PRINCIPLES OF MARKETING

THEODORE N. BECKMAN
PROFESSOR OF BUSINESS ORGANIZATION
THE OHIO STATE UNIVERSITY

HAROLD H. MAYNARD
PROFESSOR AND CHAIRMAN
DEPARTMENT OF BUSINESS ORGANIZATION
THE OHIO STATE UNIVERSITY

WILLIAM R. DAVIDSON
ASSOCIATE PROFESSOR OF BUSINESS ORGANIZATION
THE OHIO STATE UNIVERSITY

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PREFACE

This Sixth Edition, as in previous endeavors, surveys the whole field of marketing from a social point of view and gives the student a basic understanding of the principles of marketing. It reflects the dynamic progress in marketing, the cumulative teaching, research, and consulting experiences of the authors, and their added knowledge of marketing practice and thought.

More specifically, the objectives of this book may be stated as follows: (1) to present a clear-cut picture of the development and present status of our marketing system; (2) to analyze critically the marketing task, the various essential functions that must be performed in marketing, and the numerous and varied types of institutions performing them; (3) to examine the major policies that underlie the various activities of marketing institutions, with emphasis on the business, economic, and social implications of such policies; (4) to enable students to understand the numerous controversial questions arising out of the performance of marketing functions so that they may more intelligently exercise their prerogatives of citizenship; and (5) to provide the basic tools and necessary background for advanced work, not only for students specializing in marketing, but also for those in related fields.

These objectives are a continuation of those which have proved acceptable to many users of previous editions and have been so effective pedagogically. The changes in content and emphasis which constitute the major features of this revision are summarized as follows.

First, in order to reflect relatively recent important developments, a number of new topics have been introduced. Illustrative in terms of institutional changes are planned shopping centers, discount houses, and nonstore retailing, including vending machine merchandising. "Value added," as a measure of economic contribution by marketing, and motivation research are among a number of relatively new concepts or techniques which are introduced in this edition and which are treated realistically in line with their importance to the entire field of marketing.

Second, greater stress has been placed on the dynamics of marketing. Within the sections of the book that deal with marketing institutions, emphasis has been placed upon their *performance,* in terms of adaptive behavior in a changing environment.

Third, the entire content has been reworked substantially, to permit a realistic treatment of each phase of marketing in a balanced modern perspective, but without disturbing the general pattern of arrangement that has proved so acceptable to most users of previous editions. Following two introductory chapters, the student is led into a series of chapters dealing with an analysis of consumers and their characteristics. In accord with the philosophy of proceeding in an orderly fashion from the known to the unknown and from the simple to the more complex, the student is then drawn into a discussion of retailing institutions, and then into an analysis of wholesaling organizations. Attention is then devoted to an analysis of each of the basic marketing functions. This is followed by a discussion of selected major marketing policies and some social aspects of marketing.

Although much new material has been added, the total content has been held to what can reasonably be taught in an undergraduate course. This has been accomplished in a variety of ways. Some topics which are now primarily of historical interest, such as certain aspects of the consumer movement of the 1920's and 1930's, have been greatly condensed. A much more compact treatment has been accorded to certain subjects of minor quantitative significance, as consumer cooperative organizations and direct retailing by agricultural producers. Less attention has been devoted to certain refinements or more technical phases of the subject as, for example, the more involved aspects of futures trading and hedging. As a result of such changes, the number of chapters devoted to consumer analysis and to retailing and wholesaling institutions has been reduced. The same chapter arrangement has been retained for the part of the book dealing with marketing functions, but the relative importance of this section to the whole has been increased.

Fourth, it has been the continuing aim of the authors to subordinate the descriptive and factual phases of the subject to the analytical. Even more than in previous editions, attempts have been made to restrict descriptive material and presentations of statistical facts to the essential requirement of providing the student with a suitable background for understanding the formulation and import of marketing principles. By stressing significant generalizations, and probing into the "why" of the subject, it is believed that one can best obtain a balanced point of view—one which can be constructively applied to the solution of marketing problems.

Fifth, in all aspects of the revision, the text has been brought thoroughly up-to-date. Statistical material has been carefully selected from the most recent Census of Business and from other latest public and authoritative private sources. New developments in marketing practices have been carefully

considered. Economic interpretations of the most recent legislative enactments and legal decisions have been incorporated. Many new questions and problems have been added to provide a more complete coverage of the content of the text and to furnish a reasonable number of those of the situation-problem or short case type.

For purposes of this revision a number of chapters were completely rewritten. Most of the others were revised in a very substantial manner. Only a few appear approximately as they did in the previous edition, and even these have been revised to some extent.

Since publication of the first edition of this book, as a necessary concomitant in the development of a science, marketing terminology has been greatly expanded, enriched, and refined. In this work the authors have always taken a deep interest and a large part. Consequently, special attention has been given to this matter, and unusual attempts have been made to define terms with great care in order to give them exact meanings and to avoid misunderstandings. The interest in this and its importance are evidenced by the service of the senior author as special consultant to the editors of G. & C. Merriam Company in connection with updating and revising the terminology of marketing for future revisions of Webster dictionaries including *Webster's New International Dictionary*.

In this, as for previous editions, the authors have benefited from sources of inspiration and direct assistance too numerous to detail here. Many of the more significant sources are acknowledged in appropriate footnotes. To all of them, to our many teaching colleagues at The Ohio State University and throughout the world who have used the book and offered constructive comments about previous editions, to our many graduate and undergraduate students, to Mr. John Albright and Mr. Henry Wulff of the Business Division of the U.S. Bureau of the Census, to Dean Walter C. Weidler who made valued contributions to earlier editions, and to many others that we have doubtless overlooked, we express our profound gratitude.

Theodore N. Beckman
Harold H. Maynard
William R. Davidson

Columbus, Ohio
February, 1957

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1

MARKETING AS A FIELD OF KNOWLEDGE

Quite unlike his forefathers in this land or in other lands, the *ordinary* American citizen of today lives in the midst of abundance. He finds it easy to take for granted the existence and availability of all kinds of goods to satisfy his every want. If he has gleaned only a little knowledge from newspaper headlines and picture magazines, he is doubtless aware of contemporary and revolutionary developments in agricultural and manufacturing production that have made possible a constantly increasing supply of goods ever better adapted or designed for the fuller gratification of his wants. Still, he is likely to have only a vague comprehension of the significance of the marketing activities that bring to him the high standard of living he enjoys.

This is not surprising, for it is only since the 1920's that deserved attention has been devoted to marketing as a field of scientific study. This has been much too recent to allow for the development of any widespread public appreciation of the prominent role that marketing plays in our economic system. For the same reason, little popular attention has been given to the essential nature of adequate and efficient marketing facilities, so that goods produced on our farms and in our mechanized factories may flow smoothly to consumers and in a manner that contributes to the general welfare of our society.

The Meaning of Marketing

Prior to undertaking the study of marketing, it is essential to understand the exact meaning of the term, its scope, and its relationship to certain other terms. The following paragraphs will aid in accomplishing this task.

Marketing Defined. In the commonly accepted usage of the term, *marketing covers all business activities necessary to effect transfers in the ownership of goods and to provide for their physical distribution. It embraces the entire group of services and functions performed in the distribution of merchandise from producer to consumer, excluding only operations relating to changes in the form of goods normally regarded as processing or manufacturing operations.* The various methods by which these services are rendered, together with the institutions concerned and the policies adopted in the performance of the marketing functions, are necessarily an integral part of the subject of marketing.

In a broader sense, the term "marketing" embraces all business activities involved in the flow of goods and services from physical production to consumption. In this sense, it includes not only dealings in merchandise but in a wide array of services—personal, business, and professional—as well, together with dealings in intangibles like insurance, stocks, and bonds. Moreover, the term would also cover the activities pertaining to transfers of title to real estate. For various pertinent reasons, the term "marketing," as used in this book, is limited to the above-defined activities as they apply to *tangible* commodities, other than real estate, and to such services as are performed in connection therewith.

The Market. When a housewife "does her marketing," she goes to some place or places at which the goods she wishes to buy are available and there makes her purchases. When she goes to "the market," she sets out for a given store or for some shopping center. In the instances cited, neither the term "marketing" nor the term "market" is correctly used or properly understood. In "doing her marketing" the housewife is performing but an infinitesimal part of the marketing process involved in making the goods available to her at the place of purchase; even at such a place most of the marketing activity is carried on by the vendor and not by the housewife. Certainly the term "market" in the above cited instance is used in a very narrow sense when it refers to a specific place of business or to an aggregate of places of business within a limited and specified local area.

In reality, a market is a *point, place, or sphere* in which transfers in the ownership of goods are effected. The actual or physical presence of the goods is not essential since the principal characteristic of a market consists in change of title. In fact, some markets are often devoted largely to the exchange of *title* to goods rather than to the physical transfer of the actual merchandise. Nevertheless, goods tend to be concentrated at important trading points. Consequently, *a market may be defined as a sphere within which price-making forces operate, and in which exchanges of title tend to be accompanied by the actual movement of the goods affected.*

On a more general plane, the market is the mechanism by which the valuable resources of our society are allocated among the various alternative

ends that compete for their use. From the point of view of society, the basic criterion of a good market is the efficiency with which it operates. If the market is inefficient and does not help to maximize consumer satisfactions, then society cannot be content with the manner in which it is being served. It seems probable, however, that we will never have markets that operate at optimum efficiency in the economic sense. This is true because society places upon markets demands of a noneconomic character. While society seems to desire highly competitive markets, it is also strongly concerned with the welfare and security of individuals. Society wants only the most efficient middlemen to serve it, but still it desires unlimited freedom of entrance for participation in the market as a characteristic of American enterprise. Demands for efficiency or cost reduction are made upon manufacturers and middlemen. At the same time society insists upon extensive varieties of goods, broad assortments of particular kinds of merchandise, and numerous services accompanying the sale of goods, all of which are expensive to provide.

In spite of some conflict between economic goals and noneconomic desires, it is possible to formulate some attributes of a market which may make it socially desirable in our contemporary setting. In such a market the following would be found:

1. Goods and services wanted by society are produced and offered in the right quantities and qualities
2. Desired goods and services are made available at the time and place that they are wanted
3. A fair price is charged for goods marketed. This is a price which is determined by a relatively free interplay of forces of supply and demand under conditions of workable competition, and which covers the cost of making the goods and providing the services essential for their distribution
4. Adequate and reliable market information is provided to market participants, both producers (including marketing agencies) and consumers
5. Institutions performing marketing functions are dynamic, modifying their character or offerings in response to changes in consumer needs
6. The market is regulated by law to some extent to prevent abuse and for the welfare of society

The foregoing criteria are considered useful in judging markets in various specific senses in which the term is popularly used. The term sometimes is employed with a *geographical* connotation. Thus it may relate to a highly localized area, as in the case of a municipal retail market or a produce exchange, or it may embrace a region, a country, or even the whole world. "There is a world market for grain," and "A free-trade nation offers a good market for certain commodities" are expressions illustrating the point. Furthermore, the term "market" may relate to a place maintained by an *organization* for the purpose of facilitating buying and selling for its mem-

bership, as illustrated by produce exchanges and boards of trade; or it may refer to a place maintained by a municipality, or a place where people meet on certain days by common consent and through custom, as in the street marketing of farm products in certain communities. It may refer to the sphere in which price-making forces of a single *commodity* operate, or it may embrace a large variety of products. Thus, one may speak of the cotton market being brisk or sluggish without particular reference to any definite locality, although some center is usually implied; or one may say that "there is no market for anything just now," meaning thereby that there is no opportunity to sell goods at the usual market places at remunerative prices. In every case, a place or center is implied or referred to directly in the statement.

It is thus apparent that a market may be conceived of in one of three ways and may often consist of a combination of all of them. First, it may mean a geographical area. Second, it may relate to a body or organization of buyers and sellers. Third, it may apply to a combination of forces which determine price and exchange opportunity. It is in this last sense that the economist usually discusses the three types of markets that exist under monopoly, pure competition, and imperfect competition, respectively.

Marketing, Production, and Economic Value.[1] One of the least understood characteristics of marketing activities is that of their productive nature. It is unfortunate that the term "production" is used in two different ways, and this is the source of considerable ambiguity and confusion. In one sense, it is used to denote the *result of industrial activity* as in referring to the output of farms, factories, or mines. On the other hand, it is more appropriately used in referring to the *whole productive process,* and it is in this sense that it will be used in this discussion and throughout this book.

For many years economists have defined production as the "creation of utilities," which are the capacities of goods and services to satisfy human wants. Economic value may be described as the characteristics of a tangible good or service which induce people to sacrifice their efforts, either past or present, in order to obtain it. Value is largely dependent upon the attribute of utility. The only practical way in which to measure the utilities or satisfactions created by the productive process is through the expression of their values in the open market as prices which form the basis for exchange.

A brief explanation of different kinds of utilities may serve to demonstrate how production and value have been narrowly construed and associated chiefly with industrial activity, and how marketing activity is just as

[1] Portions of the discussion in this section are based on material previously published by one of the authors. See Theodore N. Beckman, "The Value Added Concept as Applied to Marketing and Its Implications," in Stewart H. Rewoldt (ed.), *Frontiers in Marketing Thought* (Bloomington: Bureau of Business Research of Indiana University, 1955), pp. 83–99.

productive and is, in fact, responsible for a very major share of the total gross national product which is created annually in our economy.

One type of utility created in the productive process is commonly known as *form* utility. It consists of the conversion or *transformation* of scarce resources to increasingly satisfying states. This may be illustrated by the conversion of copper ore to ingots, to rods, to wire, to part of the ignition apparatus, to part of the internal-combustion engine, and to part of the automobile. As the ore moved from mine to smelting plant, to rolling mill, to wire mill, to electrical machinery plant, to automobile engine plant, and finally to automobile assembly plant, it acquired additional value at each stage because at each point of its progress it was in a more satisfying or more useful state and hence worth more. No one would question whether value was added (i.e., utility created), even when the copper wire may not itself have been changed in form as it was made part of the ignition apparatus or assembled as a component of the automobile engine. Nevertheless, all are regarded as part of the transformation or form utility phase of the productive process. At each of these stages value was added, even though no consumer satisfactions whatever had yet been realized and were, in fact, still far in the offing.

In the foregoing illustration it cannot be assumed that the only utility created was that of a change in form through manufacturing activity. The ingots may have been *transferred* from the smelting and refining plant to a rolling mill that was far removed in *space;* and this may have been done *at times* when the mill could best handle the ingots. Furthermore, the two plants may have been under different *ownership,* which would involve not only place and time transfers, but also transfers between persons or firms, thereby creating what are known as *place, time,* and *possession utilities.* The same type of transfers may have been involved in the subsequent stages involving the wire mill, electrical machinery plant, engine plant, and automobile assembly plant. The example serves to call attention to the essential and productive character of marketing, even in connection with the creation of what is commonly regarded as *form* utility.

This may be demonstrated further in connection with finished consumer goods as, for example, canned soup or fountain pens. Under modern conditions, such goods are mass produced and are available in tremendous quantities at the factories where they are made. In such quantities, these goods would have practically no value if it were required that they be used by the people who made them and at the place and time of manufacture. The goods are of no value whatever *to the final consumer* until they are (1) in his *possession,* (2) at his home or other *place* of consumption, and (3) *when* he wants to use them.

To illustrate further, when a wholesaler purchases goods from the manufacturer and resells them to the retailer, valuable *possession* utility is created

involving two transfers of title with the movement of goods through the accepted channel of trade. When the wholesaler has the goods shipped to him from the factory and delivers them to the retailer, the goods are transferred nearer the place of consumption and further values are added through the creation of *place* utility. Finally, when the wholesaler and the retailer store the goods in the warehouse or on the store's display shelf until wanted by final consumers, the goods are made more useful or satisfying through the addition of *time* utility. To create all these kinds of utilities, other functions must be performed by both wholesaler and retailer. Illustrative are the financing of their inventories, assuming the risk of price changes and other hazards of entrepreneurship, advertising and displaying the merchandise to make its existence known to those who may have use for it, and keeping informed about market trends and conditions.

From the foregoing, it is clear that those who have to do with the movement of goods through channels of trade create utilities, add value to goods, and are thus an integral and major part of the productive process. Unfortunately, such a point of view has not always been shared by economists who, until fairly recent years, tended to confine their discussions of production almost exclusively to the form utility aspects, especially with reference to farming or manufacturing. The tendency in modern economic writings is to give more appropriate recognition to production in the broader, truer, and more meaningful sense. Among those who have given careful study to the matter it is now well accepted that marketing is a major aspect of the economic process and, hence, the study of marketing is the study of an aspect of economics. As a consequence, it is expected that the future will bring more widespread appreciation of the essential nature of the marketing effort and of the value added by the creation of time, place, and possession utilities in the marketing process.

Historical Emergence of a Middleman System

From the earliest period of recorded history, man has been dependent upon agricultural production and upon some forms, however crude, of handicraft or manufacturing activity. Only in modern times has he found himself relying upon middlemen to supply practically all his needs for goods. It is but natural, therefore, that form utility has tended to dominate economic thinking about production until recently. The rather youthful character of our present institutional structure for marketing may be better understood by giving brief attention to historical changes in productive effort, from primitive times down to the present.

Early Developments in Marketing. The origin of marketing is lost in obscurity. Certainly, there is ample evidence of the existence of trade among the ancient Egyptians. Numerous references to trade are to be found in the

Old Testament, and the Phoenicians in their heyday were regarded as a nation of wholesalers. Both wholesale and retail trade were well developed during the era of Greek supremacy and in the period of Roman domination.

To be sure, the articles traded in the early days of civilization were few in number. They were restricted largely to luxuries purchased by the rich, due to the costliness and dangers of transportation, the low standard of living, and the limited number of wants. Differentiation of production in the various parts of a country and deficiencies in certain essentials such as common salt and spices in certain countries also stimulated trade to no small degree but in relatively few items. Even as late as the year 1000, villages were characterized by their agrarian, independent nature and by economic self-sufficiency. In every village attempts were made, by methods now considered crude and wasteful, to raise the necessary food supply and to produce the few other necessaries of existence. With the fall of the Roman Empire trade seems to have suffered an eclipse for some centuries.

Beginning with the latter part of the Middle Ages, the advance from the manorial or village system to the town was rapid. The town became a place of craftsmen and traders. In this handicraft stage of the household system of production, skilled workers set themselves up in their homes as craftsmen, producing goods to order. The more enterprising craftsmen began to use apprentices and often produced a surplus which was sold at local markets or fairs. This practice resulted in the organization of markets and in the holding of fairs at periodic intervals. Craftsmen soon organized into associations known as guilds, which controlled both manufacturing and marketing by minute regulations, much to the detriment of progress in both. The domestic system, whereby the products of the craftsmen were sold by businessmen, superseded the handicraft stage. With increased protection by stronger and more stable governments, the towns grew rapidly and markets gradually expanded. Toward the close of the fifteenth century a period of discoveries began. It resulted in marked improvements in maritime transportation, thereby supplying an added impetus to commerce. With the development of national governments, the guilds finally outlived their usefulness, and during the early part of the sixteenth century mercantilism became the guiding principle of state policy. In brief, mercantilists argued that a country could become opulent if it sold more merchandise to foreigners than it bought from them. Only in this way could it increase its stock of precious metals which, at that time, was considered the ultimate desideratum. Naturally, this movement stimulated commerce to no small degree.

The Industrial Revolution. In the latter part of the eighteenth century, the Industrial Revolution began to usher in marked improvements in form utility production. These were continued throughout the early part of the nineteenth century, but were greatly accelerated in the United States in the period following the Civil War. The domestic stage of production was sup-

planted almost entirely by factories in which large numbers of specialized workers were employed. Elaborate steam- or motor-driven machinery replaced handicraft methods. Industry became localized, large-scale production became the goal of manufacturers, and a minute division of labor began to be considered an essential prerequisite to efficient operation.

Specialization has now reached such a point that whole communities or areas sometimes devote a major part of their energy to the production of a single commodity. Thus Pittsburgh and Gary are known for their iron and steel products; Detroit for its automobiles; Danbury for hats; Akron for tires; Wisconsin for cheese and other dairy products; eastern Colorado for beet sugar; California, Florida, and the Rio Grande valley for citrus fruits; and so on. As a result, the geographical chasm separating farm or factory and consumer has widened considerably. The agricultural producer, the processor, or the manufacturer cannot seek out the final consumer of his wares. He finds it more economical to devote his major effort to physical production, where he is presumably of maximum service, and for the most part allows someone else to dispose of his finished goods, and even to assemble his raw materials for him. Similarly, the consumer finds that any attempt on his part to purchase the numerous commodities necessary to satisfy his increasing and varied wants, directly from their makers, is the height of absurdity. He is, therefore, only too glad in the vast majority of cases to be relieved of the necessity of buying direct and to let someone else do it for him.

Effect of Industrial Revolution on Marketing. It thus becomes obvious that the present middleman system is but the outgrowth of changed conditions in industry, the outcome of a growing civilization and industrial progress. As long as towns and villages were economically self-sufficient, producer-consumer contact was feasible except for trade between countries. As soon, however, as industry was localized, large-scale physical production developed, and cities grew in importance at the expense of the rural population, maladjustments made their appearance, marketing risks increased, and an elaborate middleman system was called into existence to bridge over the ever-widening gap that separated the ultimate consumer from the manufacturer. To these factors may be added the constant pressure to increase both the scale of industrial production and production for sale instead of own use, both of which are direct results of our factory system.

Need for Middlemen. From this brief historical sketch it is apparent that few, if any, middlemen existed in primitive society—a condition that still obtains in undeveloped and industrially stagnant parts of the globe. There is hardly any surplus to exchange in primitive communities. Each family is producing practically all that is used in the home. Whenever any surplus of products of the soil, chase, or craftsman's art becomes available,

the different members of the tribe or village effect exchanges directly among themselves. Even during the early part of the handicraft stage in Europe, consumers either visited the shops of the craftsmen or the latter abandoned their loom or bench for a considerable time and at frequent intervals in order to find buyers for their wares.

On the other hand, whenever a country advanced in civilization, trade flourished as it did in ancient Sumeria, Babylonia, Phoenicia, and Egypt. In later years, the Persians, Greeks, and Romans engaged in trade to a considerable extent, which decreased in importance as these nations declined in power. In modern times, the ascendancy of trade resulted largely from the Industrial Revolution. This presented in its early days what appeared to be insuperable marketing problems. Marketing functions were therefore shifted more and more to middlemen who specialized in their performance, so that by the end of the nineteenth century the pattern for the present system of marketing was fairly well established.

Even today in the transfer of title to goods direct contact may be established. Manufacturers sometimes buy their raw materials directly from original producers, and they often purchase their requirements in semimanufactured goods, parts, equipment, and supplies direct from manufacturing sources. Even the consuming public buys a limited amount of merchandise direct from the farmer or manufacturer. The bulk of farm products and manufactured goods, however, is bought and sold indirectly through one or more middlemen. *Middlemen are, then, individuals, firms, or corporations that stand between prime producers and ultimate consumers, assume title or assist directly in its transfer, and receive a profit for the risks they assume in addition to being paid for the cost of their services or take whatever losses are incident to the assumption of an entrepreneur's functions.* Salesmen are excluded from this group, for they are not in business for themselves and, consequently, assume none of the risks of entrepreneurs and receive no profit, nor do they sustain losses from their sales efforts as such.

Classification of Middlemen. Undoubtedly the most useful classification of middlemen is that based on ownership of the goods. From both legal and practical aspects, the relationship to the transfer of title is a most significant factor in defining the position of any group of middlemen. On this basis, *all middlemen are divided into merchant middlemen and functional middlemen. Merchant middlemen buy the goods outright and necessarily take title to them.* Wholesalers and retailers are the common examples. *Functional,* or nonmerchant, *middlemen* ordinarily assist directly in effecting a change in ownership, but they *do not themselves take title to the goods in which they deal. They specialize in the performance of a single marketing function or of a limited number of such functions,* one of which is usually related to the transfer of title. Functional middlemen are best represented

by auction companies, brokers, commission houses, manufacturers' agents, and selling agents.

Growing out of the major distinction between merchant and functional middlemen is the difference in the degree of risk which they assume. All middlemen must bear entrepreneurial risks since they are in business for themselves and they may or may not be successful in securing the necessary volume for profitable operation. Merchant middlemen must, however, bear the additional risk resulting from the uncertain ability to dispose of the goods they own at remunerative prices. Functional middlemen, on the other hand, act for others in the purchase or sale of goods; hence the risks of a changing price level and of uncertain demand or supply conditions are borne by the principals in whom title to the goods vests.

There are, of course, other organizations, institutions, or agencies which facilitate the performance of marketing functions by acting in some specialized capacity. They are not, however, generally regarded as middlemen or as strictly marketing institutions, chiefly because they render no direct assistance in the transfer of title to goods—a characteristic peculiar to all bona fide middlemen and marketing organizations. Among these are railroads, commercial banks, insurance companies, ordinary warehouses, cold storage plants, marketing research agencies, inspectors, and graders. To the extent that they now perform distributive and selling functions in certain lines of merchandise, warehouses may be classed among the functional middlemen, and to that extent they constitute an integral part of the marketing system.

Evolution of Interest in the Scientific Study of Marketing

In the wake of the Industrial Revolution and the gradual development of a complex and specialized middleman system of distribution, there has been an increasing general interest in marketing activities and in the institutional structure by which such activities are carried on. This interest has been responsible for increasing attention being devoted to the study of marketing. From the early years of this century until the present, marketing study has been characterized by a gradual transition from the descriptive to more analytical methods of inquiry.

Descriptive and Qualitative Nature of the Early Literature. Early marketing literature consists of the authoritative writings which appeared during the period running roughly from the beginning of this century down to about 1920. It was also during this period that formal courses of study in marketing began to make an appearance in colleges and universities, although relatively few such courses were offered until after World War I. In most of

the early books the treatment was almost altogether qualitative in nature. The purely descriptive method usually predominated, interspersed here and there with brief analytical discussions of more or less *theoretical* economic significance. The newness of the subject and lack of quantitative data were, no doubt, responsible for a state of affairs characterized largely by discussions of "what" and "how" in relation to marketing functions and institutions.

Definitions of Marketing Subject Matter and Quantitative Emphasis. The shortcomings of the descriptive method and the prevailing qualitative treatments were not unrecognized by the early students of marketing, many of whom are still among the important contributors in the field. It was generally held that before a classified and systematized body of marketing knowledge could be developed, the subject matter would first have to be defined. This is an important prerequisite to classification in order that items possessing the same essential characteristics may be grouped together for analysis and discussion and distinguished from others of a disparate nature. Without a correct definition of the elements of which marketing is composed, scientific study of it is impossible. Furthermore, no reasonably accurate quantitative measurement of any phase of marketing can be obtained without first defining its components and delimiting the field of investigation.

The greatest single impetus to the quantitative approach was that of the first Census of Business, which was taken for the year 1929 as a part of the Fifteenth Decennial Census of the United States. It provided a complete enumeration of all business establishments, with numerous classifications, including the geographical, kind of business, method of operation, legal ownership, sales volume size, and other bases. For the first time there became available a fairly complete picture of the complicated marketing system—one revealing how goods of different kinds move through channels of distribution to consumption, the relative importance of the different channels through which the goods pass, the kind of services performed and costs incurred in the marketing process, and many other hitherto unknown characteristics of the marketing system. Subsequent Censuses of Business have been taken for the years 1933, 1935, 1939, 1948, and 1954. Thus, detailed data are now available for six different years of varying economic and social conditions and covering a total period of twenty-five years. In the chapters that follow liberal use is made of these data, for they provide the most comprehensive available picture of our marketing system and the trends exhibited in the progress of its development.

Another important contribution of the first Census of Business was the clarification of many marketing concepts. An important prerequisite to the proper enumeration and classification of business firms was a careful definition of marketing terminology. Further impetus to the movement for pre-

cise terminology was provided by various federal and state laws enacted during the 1930's for the purpose of regulating trade practices. For example, some laws dealt with brokerage fees, with taxes on retail units of chain stores, with advertising allowances, with resale price maintenance, etc. In order to enforce such laws, it was essential to state exactly what was meant by each such term and in such a manner that there would be more or less uniform interpretation.

Various pressures for better and clearer definitions have resulted in substantial agreement regarding much of the important marketing terminology. As a consequence, the collection, interpretation, and dissemination of data have been greatly facilitated and many misunderstandings and erroneous conclusions, formerly commonplace, have been avoided or at least greatly minimized.

Emphasis on Marketing Principles. The shift in emphasis from the descriptive and qualitative to the quantitative meant that much of the study of marketing became more *factual* in nature, at least to the extent that it was made in terms of *facts or empirical realities relevant to marketing problems or situations,* i.e., in terms of things, events, or conditions the reality of which (physical, material, psychological, or sociological) is indisputable and manifest (objectively or subjectively) in marketing experience or which marketing experience indicates may be inferred with certainty.

Marketing *facts* are basic to the formulation of marketing principles. After all, *a marketing principle is an explanatory statement of general truth, derived from a study of facts set up in a cause and effect relationship, that always applies under given conditions or assumptions.*

The assembly of facts in a concrete way and the detailed and comprehensive analysis of them have led to a knowledge of marketing no longer based largely on mere conjecture or on pure deductive reasoning. They have also aided greatly in the development of marketing principles, which are in the nature of settled rules of action derived from a careful analysis of marketing facts and verified in experience. These may be sharply contrasted with *policies, which are rules of action adopted by operating organizations for the purpose of insuring uniformity of procedure under similar circumstances confronting such organizations.* Being man-made and created by a specific person or group of persons for a specific purpose, policies may be altered or changed drastically almost at will, while the explanatory statements embodied in principles change only gradually, if at all, so long as the conditions or assumptions remain unaltered.

That there are many principles in the field of marketing goes without question. For example, who would deny the general truth or validity of the following principle? "Since quantities involved in wholesale dealings are so large that even a small change in price becomes significant, and since whole-

sale organizations are generally more informed with respect to changes in demand and supply conditions and all or most of them receive such information more or less simultaneously, *wholesale prices fluctuate more frequently but less violently than do retail prices.*" Very often only the statement of the general truth is made without setting forth the reasons or the sets of facts arranged in a cause and effect relationship, but such a statement is in the nature of a principle nevertheless. A few principles are thus cited below, with varying degrees of brevity, to illustrate their existence in the realm of marketing:

> "Technical products of high unit value tend to have a short channel of distribution."
>
> "As the income of a family increases, the proportion spent by it for food decreases."
>
> "Total demand of an individual or a group of persons is affected more by purchasing power than by any other single factor."
>
> "The success of a consumers' cooperative rests, in addition to efficient business management, upon its proximity to a sufficiently large, homogeneous, economy-minded membership willing to subordinate individual tastes and actions to group welfare."
>
> "Because the marketing functions are inherent in the marketing process and must be performed by someone, elimination of the middleman results merely in the transfer or shifting of functions and not in their elimination."
>
> "So long as a given type of marketing institution continues to perform essential functions in a reasonably efficient manner, its existence is economically justified and its continuity is well assured."
>
> "In a buyers' market the competition among manufacturers on the one hand and the opportunity for mass purchases at attractive prices on the other lead to integration of marketing functions."
>
> "In a competitive economic order it is impossible for an organization continually and generally to undersell all its competitors."
>
> "Unless the use of loss-leaders results in an increase in total volume otherwise not attainable for the user, it tends inevitably to lead to a recoupment of the losses on other items that must of necessity be overpriced."

Emphasis on principles tends to enhance our understanding of the marketing system and thus leads to more effective control of its forces. It also tends to subordinate the descriptive material to the analytical. When a sufficient body of principles is adequately developed, it becomes possible to supplement our knowledge of marketing practice with that derived from the development of sound marketing theory.

Marketing Theory. Since the end of World War II, a number of articles and books have appeared in which considerable discussion has been devoted

to the nature of the generalizations thus far developed in the study of marketing. A number of scholarly writers, while usually acknowledging the existence of principles as explained above, have lamented the lack of a more theoretical approach in marketing study. When due consideration is given to the newness of the scientific investigation of marketing, it appears to the authors that at least reasonably fair progress has been made in the formulation of sound theory.

Properly considered, *a theory may be viewed as consisting of a related or coherent group of facts, principles, and hypotheses.* A hypothesis is a conjectural explanation of variation, a tentative supposition provisionally adopted to explain certain facts and to guide in the investigation of other facts that might in a general way verify or disprove the hypothesis. Where a related body of principles has been developed to explain a class of marketing phenomena, a theory pertaining to such phenomena may be said to exist. In areas where the number of definitely formulated principles is at present too limited to afford a complete and meaningful explanation, the available knowledge may be supplemented with hypotheses, and a theory thereby developed. Viewed in this light, there can be no doubt as to the existence of theory in marketing. Certainly there are many areas in the literature characterized by a group of related principles and hypotheses which have been generally agreed upon even though not fully verified. Illustrative of such matters are those pertaining to the selection of channels of distribution, marketing functions, cooperative marketing, price determination, and consumer behavior.

At the present stage of development of marketing knowledge, it seems that a definitely theoretical approach would be more appropriate for advanced study wherein one gives specialized attention to but one aspect of marketing. The field of marketing is, however, so vast and is composed of such a large number of complex and varied elements that the development of a body of generalizations so inclusive as to be properly described as "the theory of marketing" appears highly improbable. Instead of one theory, it appears more likely that marketing theory, when more fully developed, will consist of numerous complementary theories of limited scope, built upon the formulation of additional principles, just as there are in economic theory a number of theories of wages or of rent. Attention to the theoretical aspects of marketing by leading thinkers in the field is therefore highly desirable because it raises important questions which point the way to further investigation of debatable issues. This gives direction to the application of scientific inquiry in areas of marketing hitherto inadequately explored in an objective manner through basic research, and it should contribute to the future development of a more complete and integrated body of marketing knowledge.

Major Approaches to the Study of Marketing

There is some disagreement as to how the study of marketing may be best approached. Numerous approaches have been recommended from time to time by various writers. Those that have received the major share of attention are identified as the commodity, the institutional, and the functional approaches. A brief explanation of each is deemed desirable, before explaining the approach in this book.

The Commodity Approach. In the commodity approach, the marketing system is examined for each of a number of specific commodities. The usual plan calls for a discussion of the sources and conditions of supply of the commodity in question; the nature and extent of the demand for it; channels used in its distribution; the functions performed by the various links in the chain of distribution; price, brand, advertising, and other policies developed in the marketing of the commodity; and special features of marketing significance peculiar to the commodity.

The chief recommendation of the commodity approach is its concreteness, all facts relating to a specific product. The student acquires a special terminology, a sort of trade patois. Much background material is obtained on supply and demand factors. Recognition is also given to variations in the character of the commodities and the effect of such differences upon the marketing structure. On the other hand, this approach results in excessive repetition; it is time-consuming and tends to overemphasize the effect of differences in commodity characteristics upon the marketing system. For many commodities, identical channels of distribution are used and similar marketing techniques are applied. It is believed that the similarities in the marketing of most commodities are by far greater than the differences. The underlying principles are alike, and the differences are often those of adaptation. Moreover, to deduce all essential principles of marketing by this method and to cover the entire field adequately, more time is required than provided for in the average marketing curriculum.

For the reasons just indicated, the commodity approach has often been modified; and instead of dealing with specific individual commodities, attempts have been made to deal with classes of commodities that are closely related. Thus one may study the marketing of agricultural products, of industrial goods, of minerals, or of manufactured goods. In the majority of cases, however, courses of this type are of an advanced character, superimposed upon a first course in marketing, or else are given as a first course in schools of a specialized type.

Institutional Approach. Under this system each segment of the marketing mechanism is described and analyzed. For example, our retailing system is dissected into its component parts, each type of retail institution is de-

scribed, its place in the retailing structure is shown, the functions performed by it and cost of operation are examined, competitive conditions are scrutinized, trends are indicated, and its economic position is appraised. The same procedure is followed with the wholesaling system and with other phases of the marketing structure.

This approach may be described as anatomical in character. A major reason for its popularity is that our economic system is organized, and its accounts are maintained, on an institutional basis. In order to obtain many kinds of quantitative marketing information, it is necessary to rely upon the reported experience of companies or business establishments that have been classified according to the *major* activity in which they are engaged; e.g., wholesaling, retailing, manufacturing, etc.

The chief objection to this approach is that it is not likely to be sufficiently critical and analytical. Moreover, a thorough knowledge of the institutions for the purpose of developing the essential principles of marketing requires more detailed information about each marketing organizational segment than can be afforded in a single course. For this reason, such treatment is generally reserved for advanced students, in separate courses, as in retailing or wholesaling.

Functional Approach. This may be termed the physiological method of treatment. Accordingly, marketing is viewed from the standpoint of activities or functions. The entire field is broken down into a limited number of economic services or functions, such as buying, selling, transportation, and so on. Each function is then analyzed so that its nature, need, and importance may be determined, in relation to both marketing institutions and commodities or classes of commodities. The emphasis is upon the functioning or physiology of the marketing system, rather than on the anatomical structure or mechanistic part thereof or on the commodity in connection with which the function is being performed. *The very definition of marketing as a process or as a group of certain types of activities calls for a functional treatment of the subject.* It is thus possible to throw the searchlight on the effectiveness with which a given function is being performed and the price paid for its performance. Furthermore, duplication and repetition are reduced to a minimum, and a better understanding of the marketing system can be obtained within a relatively short period of time. The major defect of this method of approach is abstractness, which can be overcome by an appropriate selection of illustrative material.

Approach Used in This Volume. In this book, major emphasis is placed on the functions of marketing, or upon the performance of the economic services falling in this area. But in order to understand the functioning of the marketing mechanism, one must of necessity first familiarize himself with the structural elements of the field; hence consideration is given to the

marketing institutions before any elaborate discussion of functions is attempted. To lend more concreteness, some discussion of the marketing of a selected number of commodities is also presented, and various products are frequently referred to for illustrative purposes throughout the book. After all, marketing functions are not performed in a vacuum; they are performed by certain institutions and in connection with specific goods. Moreover, whatever the approach, which is but a matter of emphasis, proper consideration calls for analysis and for critical treatment.

In addition to utilizing the three major approaches heretofore described, the discussion is also supplemented by historical material and by value added and cost data. In short, the authors have given major emphasis to the functional treatment but have recognized the necessity of weaving various approaches into a pattern that reflects realistically the dynamic operation of our marketing system.

Point of View. To be scientific and impartial, the study of marketing must be approached from a social or consumer point of view. There are several reasons for this. First, all people are consumers. Regardless of one's occupation or profession, it is inherent in the nature of circumstances that he take the consumer point of view in purchasing the things wanted for personal or family living. Second, ultimate consumers are generally unorganized and hence are not as vociferous as agricultural producers, manufacturers, or middlemen who have strong associations to represent their own viewpoints on controversial questions. Third, consumer welfare is paramount among the economic goals in our society. There is widespread acceptance for the concept that our economic institutions exist primarily for the purpose of serving the consumer. This suggests a corollary, namely, that the economic system must be judged by the criterion of satisfactions which it brings to consumers.

Finally, it would be very difficult to approach the general study of marketing from other than the consumer point of view. This is because there are a number of major interest groups in the marketing system and their interests, at least in the short run, are often in conflict. In self-interest, a common attribute of all mankind, farmers seek to obtain the highest possible prices for their products. For the same reason, manufacturers or processors attempt to purchase agricultural raw materials at the lowest possible figure and strive to maximize their own profit when dealing with middlemen. In the same vein, merchant middlemen attempt to buy at low prices and to sell at as high prices as seem appropriate under current conditions of supply and demand. Consumers often feel that their best interests cannot be readily identified with those of the middleman from whom they make purchases, or with those of farmers and manufacturers when buying directly from them.

The matter is not quite as simple as even all this. Marketing institutions on the same level are sometimes in conflict with one another. Take the field of retailing for an example. That which may prove advantageous for chain stores may be inimical to the interests of independent retailers, and both may actively oppose anything that may be of direct benefit to consumers' cooperative associations or to manufacturers who sell direct to the consumer by house-to-house canvassing or by mail.

It is obvious, then, that in the consideration of every important marketing problem different interests are necessarily involved and that these may be at substantial variance and even in direct conflict. It is equally obvious that all interests concerned with the problem must be duly considered, partly for the sake of fairness, but largely in order to insure their essential continuous functioning in our economy. Paramount, however, must be the interest and welfare of the ultimate consumer, for only in such a manner can our marketing system be best evaluated and appraised.

Questions and Problems

1. Define or briefly explain the meaning of each of the following terms:
   a) marketing
   b) market
   c) utilities
   d) middleman
   e) functional middleman
   f) merchant middleman
   g) marketing principle
   h) marketing theory
2. It has been said that the term "production" has been used both in a narrow and a broad sense. Explain both interpretations and indicate which seems the most appropriate.
3. What different kinds of utilities are recognized by economists? Which of these are usually associated with marketing and which with manufacturing?
4. What characteristics of a market make it socially desirable? Explain.
5. Explain how value is added through marketing activity.
6. What are the main advantages and disadvantages of studying marketing by using the commodity approach? The institutional approach? The functional approach?
7. What approach to the study of marketing is suggested by the text authors' definition of marketing? Explain.
8. Since marketing activity is as old as trade, how can you explain the relatively recent development of marketing literature?
9. Examine the definition of marketing given in a standard dictionary. How does this definition compare with that given in the text? How can you explain any differences that you have observed?
10. Is marketing a part of economics, or is economics a part of marketing? Explain.
11. What is meant by "a fact," "a principle," "a theory"? Is the meaning of such terms of any significance to a student of marketing?

12. What is meant by inductive reasoning and deductive reasoning? Which was most common in the early marketing and early economic literature? Why?
13. Mr. X, a farmer, met Mr. Y as he was driving to church on Sunday. X told Y that he would like to buy 10 bushels of seed potatoes from Y and the price was agreed upon. Two days later the potatoes were delivered by Y to the home of X. The next Saturday night, when they met in town, the vendee paid the vendor. Where was the market?
14. What evidence is there that in the future marketing will be viewed in a more scientific manner?
15. What information does the Bureau of the Census gather relative to marketing? How might a manufacturer or wholesaler use this information? Cite a few specific applications that might be made of this material.
16. What effect did the Industrial Revolution have on marketing?
17. How can a student of marketing justify the time which he spends in defining terminology? Would it not be much better to spend this time in analyzing and solving marketing problems?
18. "The government should not use public funds for research purposes in any given field such as marketing. Doing so would be unfair to farmers, manufacturers, and consumers who would necessarily be required to pay part of the costs through taxation. Let us not subsidize improvements in the operation of middlemen at the partial expense of these other groups." Discuss fully the effects and implications of such a position.

2

MARKETING—ITS TASK AND IMPORTANCE

Narrowly conceived, it is the task of marketing to dispose of all the products of our farms, factories, mines and quarries, forests, fisheries, oil wells, and hunting and trapping; also to dispose of the products that are imported from other countries. Properly performed, the effect is a minimum of waste and, through the encouragement thus given, a maximum of production. From the seller's viewpoint the performance of this task is judged by the ability of the marketing system to move all goods and services from production to consumption with the least difficulty and at remunerative prices. The consumer's appraisal, however, is based upon his ability to secure the goods and services he wants in the manner desired at the most reasonable cost.

In its truer and more comprehensive sense, the marketing task encompasses much more than that. It also embodies, through adequate and continuous market analysis and study, a predetermination of what goods are to be produced or imported and in what quantities. It is equally in its province in some measure to influence and direct demand for goods and services. At all times it is the marketing task to provide a system sufficiently dynamic and flexible so that its functioning and institutions may be readily adapted to the varying needs of marketing increasing and fluctuating varieties and quantities of goods and to the changing wants of consumers for both goods and services.

In order to gain a better appreciation of the role of marketing in our economy and in the everyday lives of all our people, it is necessary to obtain some picture or conception of marketing and its scope. This may be done by giving consideration both to certain quantitative measures and to some basic conceptual factors that are indicative of the nature and probable extent of the marketing task.

Quantitative Measures

At any given time, the importance and magnitude of the marketing task may be approximated by a number of quantitative measures, including the following:

1. Personal consumption expenditures, which is the end result of marketing efforts
2. Volume of trade transacted
3. Vastness of the institutional structure for the performance of marketing activities
4. Employment in marketing, or the persons who do the job
5. Value added by marketing

Inclusion of Services in Macro-economic Treatment of Marketing. In Chapter 1 it was indicated that the term "marketing" as used in this book is limited to the specified activities as they apply to *tangible* commodities other than real estate. Accordingly, it is not intended to deal in this volume with the marketing of services other than those that are performed as part of the marketing of tangible goods and are therefore incidental thereto. To this there is but one important exception. Services are included when dealing with certain aggregate data like total personal consumption expenditures, personal income (total and disposable), and other aspects where the subject is approached from what might be termed as the *macro-economic* viewpoint—having to do with the analysis of the functioning of the economy as a whole—rather than from the *micro-economic* angle which is concerned with the analysis from the standpoint of the individual firm. The more comprehensive picture thus presented also points out the nature and extent of the areas in the economy that are excluded from the detailed treatment, marketing-wise, in this volume.

To be sure, except perhaps for payments of rent (actual and imputed), tangible goods are involved in varying degrees in the consumer expenditures for services, and such goods must go through the marketing process. For example, coal is marketed to public utilities which use it in generating power; cleaning fluid must be distributed to dry cleaning establishments; the marketing of construction materials is a prime necessity for the repair of dwellings; supplies and equipment must be sold to physicians, dentists, and hospitals in providing medical care; and automobile repair service usually involves the use of tangible goods in the form of parts and accessories that become an integral part of the repair job in addition to the equipment and supplies used by the repair shop in doing the work, all of which must be marketed both to the repair shop and to the ultimate consumer.

Personal Consumption Expenditures. In any given year, total personal consumption expenditures represent the level of living of our people. At

the same time, but subject to the limitations pointed out above, they are an appropriate measure of the magnitude of the marketing task because, except for government expenditures, they mark the end result of all economic effort including that of marketing and represent the value of goods and services currently delivered by the nation's economy to its people for use and absorption. In a sense, they also furnish a basis for judging our capacity to consume under given economic and business conditions and thus aid, in a very general way, but in a restricted sense, in determining the nature and magnitude of the marketing task.

In 1955, personal consumption expenditures amounted to $254 billions, an increase of 222 per cent over the level of $79 billions reported for 1929, the most prosperous year in our pre-World War II history. Much of this increase may be attributed, however, to the higher price level prevailing in the latter year. The Consumer Price Index of the U. S. Bureau of Labor Statistics was, in fact, 56.2 per cent higher in 1955 than in 1929. When proper statistical adjustments are made to compensate for the effects of price changes, the result is that the increase in constant dollars or in real volume was still 106.7 per cent over 1929.[1] Thus, over the quarter-century span of years, it is evident that the marketing task had more than doubled.

Volume of Trade Transacted. The data on personal consumption expenditures roughly measure only the end result of marketing activities; and the same is true of the gross national product, which is the market value of the output of goods and services produced by the nation's economy. Neither fully reflects the scope of the marketing task, mainly because it is usually necessary, before goods reach ultimate consumers, that they change hands and ownership two or more times in their movement through the channels of trade.

In ascertaining the *total volume of trade* transacted, it is first necessary to determine the value of goods marketed by original producers in agricultural or extractive industries, by manufacturers or processors, and by importers. To this must be added the sales of wholesale establishments and retail stores, and sales and other receipts of personal, business, and repair service establishments. The sum of all of these figures includes considerable duplication in economic value because manufacturing companies, for example, obtain many of their supplies of raw materials from agricultural and extractive industries, and their value is again reflected in the sales of manufactured goods. The value previously contributed by manufacturing and extractive industries is again included in the sales of wholesale estab-

[1] The Consumer Price Index (1947–49 = 100) amounted to 114.5 in 1955 as compared with 73.3 in 1929. The real volume of consumption, as represented by data reported for total personal consumption expenditures, was $222.7 billions in 1955 as compared with $107.7 billions for 1929, both expressed in 1947–49 average prices.

lishments. All previous contributions are included in retail store and service establishment sales data, along with that which is added by the functions performed in these particular businesses.

The total volume of trade varies from one year to another, depending upon the physical output of the nation's economy and the monetary values assigned to goods and services as reflected by the price level that happens to prevail. What is of special significance to the student of marketing is the fact that *the total volume of trade usually amounts to about 3.5 times the level of current expenditures for consumption.* In our complex order of economic specialization the marketing system must, therefore, provide the facilities to accommodate a volume of trade several times as great as the aggregate of expenditures for current ultimate consumption.

Vastness of the Marketing Structure. Another way of gauging the importance of marketing is to ascertain the character of the institutional structure which has evolved to perform the marketing functions that are necessary to support this volume of trade. To be sure, all kinds of business establishments are engaged in marketing goods and services. Agricultural producers, manufacturing establishments or factories, mines, wells, and quarries in the extractive industries are not, however, usually included within the scope of the institutional structure for marketing. While concerned with marketing to some extent, their primary contribution is that of creating form utility.

If attention is confined to establishments that are engaged principally in marketing goods and services (commonly referred to as the "distributive trades") the record is still very impressive. There were in 1954, according to the Census of Business, 1,721,650 retail establishments, 253,618 wholesale establishments,[2] and some 786,000 business, personal service, and repair establishments. Thus, the total number of establishments primarily engaged in marketing amounts to something in excess of 2.75 millions. Even this is a very conservative appraisal because it does not include any transportation agencies, banks and other financial institutions, radio and television broadcasting companies, legal firms, accounting firms, and many other businesses whose work is principally or at least substantially that of facilitating the marketing process.

Employment in the Marketing Structure. Still another criterion is the number of people employed in marketing. This is impossible to determine exactly because so many people in the agricultural, extractive, and manufacturing industries are engaged in the performance of marketing functions, either partially or on a full-time basis. The number so employed, or the

[2] Includes the authors' estimates for chain store warehouses which are not included within the *U. S. Census of Business—Wholesale Trade.*

portion of time devoted to marketing by those who have a variety of duties, has never been ascertained with any degree of accuracy.

If attention is again confined merely to marketing establishments or the so-called distributive trades, employment within this specialized segment of the economy in 1954 amounted to some 16 million persons, of which 10 million were engaged in retailing, 2.8 million in wholesaling, and 3.2 million in the various service industries enumerated in the Census of Business.[3] Employment in such marketing establishments was slightly more than one-fourth the total number of 61,238,000 persons employed in the civilian labor force in that year.[4]

Over the long run, the proportion of the civilian labor force employed in marketing has exhibited an upward secular trend as work on farms and in factories has become more mechanized and more specialized, on the one hand, and the task of marketing has increased in magnitude and complexity, on the other. In one major research study it was indicated that the number of persons employed in the distribution or marketing of commodities was, in 1950, more than four times as great, *relative to the number engaged in the production of commodities,* as it was in 1870.[5]

Value Added by Marketing. The most meaningful manner of judging the importance of marketing in our economy is by measuring the value that is added to goods by the performance of marketing functions. Unfortunately, widespread interest in such measurements is of very recent origin. Consequently, accurate data regarding the total contribution of marketing effort are yet to be compiled.

Reasonably comprehensive, though incomplete, estimates are available for value added in the process of marketing finished consumer goods, as measured by ascertaining the spread between the value of commodities leaving the distributive system and their value when they entered the system. Such measurements indicate the value contributed by retailers and by wholesalers (when commodities are handled by them) between the time of sale by manufacturer until the time of sale to the ultimate consumer. For all consumer goods, the total value added by such marketing establish-

[3] Data are from the U. S. Census of Business for 1954, various publications. Totals for each segment are obtained by adding data reported for proprietors and paid employees in individual establishments and in central administrative and auxiliary units of multi-unit organizations. Also included is an estimate, by the authors, of some 936,000 unpaid family workers in unincorporated retail stores.

[4] "Business Statistics," Supplement to the *Survey of Current Business,* 1955 ed., p. 56.

[5] Harold Barger, *Distribution's Place in the American Economy Since 1869,* (Princeton, N.J.: Princeton University Press, 1955), pp. 7–8. In this source it is estimated that employment in commodity distribution amounted to 88 persons per 1,000 persons engaged in commodity production in 1870. In 1950, employment in commodity distribution amounted to 407 persons per 1,000 engaged in commodity production.

ments amounts to about 37 per cent of the final retail price. There are, of course, significant variations among different types of commodities. For commodities distributed through various kinds of marketing agencies, the value contributed by the retailing and wholesaling system is approximately as follows: chain grocery organizations, 20.5 per cent of retail value; candy stores, 44.8 per cent; department stores, 38.7 per cent; furniture stores, 44.9 per cent; drugstores, 48 per cent; and jewelry stores, 52.9 per cent.[6]

Such measurements greatly understate the *total value contributed by marketing* effort because they do not take into account the value added by marketing raw materials from farm to factory, by marketing manufacturing equipment from one manufacturer to another, by marketing semi-manufactured goods and parts between different stages in the process of manufacturing commodities, by marketing raw materials and supplies which enter into the creation of services in the service industries, and by the marketing of consumer goods by others than retailers and wholesalers. They do, nevertheless, add something to our ability to visualize the magnitude and importance of marketing in our economy.

Some Basic Conceptual Factors

While the foregoing discussion may serve to indicate quantitatively the significance of marketing effort, it does not reflect adequately the complexity of the task. Careful study of marketing in terms of certain basic concepts may prove more helpful in this regard. Knowledge of them should also contribute to an understanding of much of the discussion in subsequent chapters. The basic conceptual factors to be introduced in the following sections include:

1. The variety and classes of goods marketed
2. The marketing functions
3. Channels of distribution

Variety and Classes of Goods Marketed

To the end of satisfying the wants of ultimate consumers, hundreds of thousands of articles move daily through the arteries of commerce. Because of the very large number, it is impractical to analyze the characteristics of each commodity or product; hence, goods are classified to facilitate discussion and to make the study of marketing comprehensible.

Classification of Goods. The following classification of goods is significant because of the differences in their origin, destination, the distributive

[6] *Ibid.*, p. 92.

channels through which they pass, and the special marketing problems to which they give rise:

- I. Consumer goods
  - A. Agricultural products
  - B. Products of extractive industries
  - C. Manufactured goods
    1. Convenience goods
    2. Shopping goods
    3. Specialty goods
- II. Industrial goods
  - A. Agricultural products (raw materials)
  - B. Products of extractive industries
    1. Raw materials
    2. Supplies
  - C. Manufactured products
    1. Semi-manufactured goods
    2. Parts
    3. Machinery (installations)
    4. Equipment
    5. Supplies

While subject to some limitations, the basic classification according to *destination* is of great importance. Industrial goods are purchased by business units, not for personal consumption, but to assist in, or to enter into, the production of other goods or services. In contrast with consumer goods, they are usually marketed under conditions where transactions involve large dollar amounts; they are often purchased according to specifications and on the basis of rational motivation; and they are more subject to the influence of cyclical business fluctuations. Consumer goods, on the other hand, are purchased by individuals or families because of the type of satisfactions they are expected to yield in consumption. They are bought by the consumer usually in small quantities, generally without careful advance planning, and often on the basis of nonrational or emotional considerations.

The secondary classification, according to *origin,* is also very useful. Because of the vagaries of nature, the quantity and quality of agricultural production are not easily controlled; because of the very large number of relatively small producers, there are unusual problems of assembling for shipment to markets; partly because of the acceptance of agriculture as a way of life as well as a form of business operation, there arise more problems of social control and more forms of public assistance to agricultural production and marketing. Products of the extractive industries (e.g., mining, quarrying) are, in a sense, a gift of nature. Since they are necessarily taken from the ground at the place and in the form that they exist, there is no freedom of location, but there are unusual problems of grading and

transportation to markets. Manufactured products are in marked contrast since the quality of production can be controlled in relation to standards; quantity can be readily adjusted to market demand; and plant location decisions can be made on the basis of marketing as well as manufacturing cost factors.

Special marketing problems and distribution methods associated with the other subclassifications shown above are indicated in the following more detailed discussion of specific classes of goods.

Products of Agriculture and the Extractive Industries. Agriculture supplies a large proportion of the world's foodstuffs and industrial raw materials. Many products, such as fruits, vegetables, poultry, and eggs, are ready for consumption when leaving the farm. Others, such as grain, livestock, and textile fibers, are raw materials and must pass through one or more manufacturing processes before they are available as consumption goods or for use in further production. Certain products at the time of leaving the farm may function either as raw materials or as consumer goods. Milk and cream are still sometimes delivered unchanged to the household, but usually pasteurization or homogenization and bottling may introduce a single manufacturing step. Other supplies of milk and cream become the raw materials of butter and cheese manufacturers.

Products of the extractive industries, such as mining, lumbering, and fishing, also consist of both consumption goods and raw materials. Some coal, for example, leaves the mines destined for household coal bins. A larger tonnage becomes raw material or supplies for industry and transportation and is used in the productive process.

The distribution of consumer goods often differs from that used in marketing raw materials, and the marketing mechanism for raw materials from the farm frequently differs from that used in the distribution of raw materials from the extractive industries. For example, the extent to which middlemen are used in marketing raw materials depends upon such factors as the number of processing stages through which the material goes, its ultimate uses, and the scale of production and consumption. In general, raw materials from the farms, with the exception of those sold to local consumers and manufacturers, pass through the hands of more middlemen than do the products of forests and mines, largely because of the smaller scale of agricultural production. Consumer goods from the farms frequently must be concentrated by local shippers for economical transportation, whereas manufactured consumer goods, because of the larger scale of their production, go through no such concentrating process.

Semi-manufactured Goods and Parts. Semi-manufactured goods, such as pig iron, copper, most flour, and lumber, represent commodities which must have further processing before they are ready for use by the final

consumer or are received as equipment and supplies by business institutions. From one point of view, parts for assembly into goods ready for consumption or for use as equipment may be regarded as semi-manufactured goods, since they must go through a final process, known as assembling, before they are ready for use. Examples of such goods are automotive parts, or electric motors which become a part of vacuum cleaners and washing machines. From another point of view, however, they should be separately considered. Parts usually have a double market—consumer and industrial—while semi-manufactures are intended only for industrial use. In general, the scale of both production and consumption of semi-manufactured goods is large, the number of producers and consumers small, and sales are frequently made by their producers directly to industrial and commercial users.

Machinery, Equipment, and Supplies. Machinery, equipment, and supplies refer to classes of goods used in business and which do not become a part of the finished product. Oil, stationery, office equipment, machinery, and store fixtures are familiar examples. Marketing methods and channels differ widely with respect to these goods. Much machinery is manufactured to the order of the user and sold directly to him. In some cases, as in large machine installations, if the seller has important patent rights, the purchaser has little choice of source of supply. Selling costs may be quite low. On the other hand, maximum selling costs may be experienced in the sale of equipment where the seller faces the task of converting reluctant and uninformed buyers to the use of his product.

Certain goods may fall into more than one of these classes, depending upon the uses to which they are put. Coal, for example, as used by the householder is a consumption good; in the hands of the artificial gas manufacturer it is raw material; and it constitutes a supply to the lumber manufacturer who uses it for the generation of power.

Consumer Goods. The term "consumer goods" is applied to the entire range of commodities used by final consumers; these goods constitute the ultimate objective of production and distribution. Consumer goods are of three classes, namely: convenience goods, shopping goods, and specialty goods.

Convenience Goods. Convenience goods are those articles that consumers wish to purchase with a minimum of effort. Such purchases usually involve a small unit price. The consumer is familiar with the goods wanted, and his demand is clearly defined as soon as the want is recognized; also its prompt satisfaction is desired. The demands of the consumer with respect to such merchandise lead him to expect ready accessibility. Tobacco, drugs, confectionery products, some hardware, and staple groceries are good examples of convenience goods.

Once a consumer recognizes that his stock of tobacco is low, he wishes to replenish it with the least possible trouble and effort. The individual purchase is small and frequent. The buyer knows the particular kind of tobacco desired, and it is convenient for him to find a seller at no great distance from where he is at the time when his want is realized. This explains why tobacco is sold in so many stores in any large community. Thus, a tobacco manufacturer, if he is to realize maximum sales, must have his products in a multitude of retail stores. The difficulty of selling directly to thousands of retailers—many of them small—leads him to employ wholesalers who can effectively distribute the products to the retail trade.

The housewife in her day-after-day purchase of groceries prefers a readily accessible store. Her preferences explain the development of the hundreds of neighborhood groceries and supermarkets found in every large city. Buyers of drugs and of minor hardware items have similar preferences, with the result that the stores selling these items are numerous and widely scattered.

Since there are many stores handling convenience goods, the volume of business done by the average store tends to be relatively small. With thousands of retailers, each buying small quantities of any one manufacturer's goods, wholesalers become an important distributive factor. The retailer whose stocks include items produced by hundreds of different manufacturers would find it difficult and very expensive to buy directly from manufacturers. Much time would be consumed in buying and in accounting, and transportation costs on the many small shipments would be excessive. Moreover, many manufacturers of convenience goods would be unable or unwilling to assume the burdens and risks of direct selling.

It should not be assumed that the distribution of convenience goods always involves the wholesaler. Some manufacturers produce lines of merchandise sufficiently extensive to make it practicable to deal directly with retailers. A certain large soap manufacturer with a diversified line of goods, a food products manufacturer with more than "57 Varieties," and some others sell directly to retailers, at least in part, since the unit order is increased by the size of the line of merchandise offered. However, most manufacturers of convenience goods find it profitable to sell through wholesalers, and most retail distributors of such merchandise regard the wholesaler as their logical source of supply.

The neighborhood store, whether operated by the owner or of the chain store type, and whether operated singly or as part of a group of stores in a shopping center, is the outstanding institution in the distribution of convenience goods. The manufacturer of such goods must be represented in these stores if he is to secure maximum sales. Convenience of customers, however, calls for retail distribution of such goods not only in stores of residential neighborhoods and in shopping centers but in downtown stores as well. The convenience of tobacco buyers is promoted by having sellers

located downtown in the principal shopping center as well as adjacent to their homes. The housewife may find the neighborhood drygoods store a great convenience in purchasing such articles as thread, pins, and needles. On the other hand, if she happens to be downtown on a shopping tour and has purchased the piece goods for a dress, she may find it more convenient to buy thread and needles in the same store in which she purchased the piece goods.

Because of the frequency of purchase and use of convenience goods, the consumer ordinarily is reasonably well informed regarding the characteristics of at least several brands of each type of such goods. For this reason, the shopper needs little or no assistance from salespeople in making purchases. Hence self-service merchandising techniques have attained the highest degree of development in the marketing of convenience goods.

Shopping Goods. Shopping goods are in contrast with convenience goods in that the consumer desires to compare prices, qualities, and styles at the time of purchase. Unlike the purchaser of convenience goods, the shopper's concept of what to buy and where to buy it is not clearly defined when the shopping expedition is planned or begun. The shopper wants to compare the offerings of a number of stores and make a decision on the basis of actual comparison of the various offerings. The purchase is of sufficient magnitude or significance to warrant some expenditure of time and effort in the way of a trip to a shopping center.

Shopping goods are not purchased, by most persons, as frequently as are convenience goods. Convenience in buying is overshadowed by the desire to institute comparisons, which are facilitated by a grouping of the stores selling shopping goods. The most important groupings are to be found in central downtown districts where department stores and specialty stores selling such merchandise as shoes, clothing, jewelry, and millinery abound. Other smaller, shopping goods concentrations are to be found in secondary or neighborhood shopping centers. Increased traffic congestion, parking limitations, and the growth of our cities are increasing the importance of such centers.

Stores of the residential neighborhoods cannot build a large volume of business in shopping lines, because the limited volume of business available in any one neighborhood does not permit these stores to carry sufficient assortments of merchandise to provide a basis for comparisons.

The retail distribution of shopping goods contrasts sharply with that of convenience goods in many ways, especially in the number of retail stores selling the merchandise. Shopping goods tend to be sold at a relatively small number of large or specialized retail stores, while convenience goods are sold in a large number of relatively small stores. Since the department stores and most specialized stores selling shopping goods are centrally located,

either in the downtown shopping districts of cities or in well-developed secondary shopping centers, they draw their patronage from a wide territory and are often very large institutions. The sales volume of typical shopping goods stores is large enough to permit them to buy much merchandise directly from manufacturers. Moreover, many manufacturers of shopping goods such as women's clothing make a relatively full line of goods so that their *unit of sale* is large enough to encourage direct selling.

Specialty Goods. Specialty goods are those that have some particular attraction other than price, which induces the consumer to put forth special effort to visit the store handling them. The attraction lies in special qualities which differentiate the goods from similar merchandise with the result that the consumer does not care to make comparisons before purchasing, or it may reside in the distinctive characteristics of the store handling the merchandise. Specialty goods contrast with convenience goods in that their purchase is sufficiently important and infrequent to induce the consumer to visit rather inaccessible sources of supply, if necessary, and to postpone action until the store can be visited.

Some of the well-established brands of men's clothing and major household appliances such as vacuum cleaners and dish washing machines are examples of products often purchased as specialty goods. Many men confine their clothing purchases to a single manufacturer's line and habitually patronize the same retailer. To them the particular brand has distinctive and favored characteristics. They will take the trouble to visit a downtown store, partly because they strongly prefer a special brand and because they buy at considerable intervals of time. Moreover, a substantial sum of money is involved, and consumers will expend much effort in buying, in proportion to the importance of the individual purchase.

While specialty goods are ordinarily of high unit value, this is not necessarily the situation. The test lies in the strength of the preferences which exist for the distinctive qualities of a particular good. These qualities may be genuine differences from the qualities of other similar goods, or they may exist only in the minds of consumers. For example, some men have such strong preferences for a particular brand of cigars or smoking tobacco that they go to considerable trouble to visit out-of-the-way stores where the brand is sold. A limited number have cigars manufactured or tobacco blended to suit their individual tastes. If they refuse to accept substitutes when the desired brand is not available and are willing to expend considerable effort in making purchases, then the article must be considered a specialty good, even if there are other products with exactly the same characteristics and capable of producing the same satisfactions.

The manufacturer of a specialty good may find it unnecessary to have a wide retail distribution. In fact, there may be distinct advantages in

limiting his distribution to one exclusive retail agency in each community. Such a practice may simplify his selling problems, and at the same time encourage the selected retailer to push the line aggressively and furnish desirable service to consumers. Because consumers seek out the local dealer, the fact that the number of retail outlets is limited may prove no detriment to the manufacturer. The small number of stores necessary to the effective distribution of specialty goods encourages the manufacturer to sell directly to the retail trade.

Some Reservations. The classification of merchandise described above is subject to several qualifications. Obviously, it is based upon the buying habits of consumers. Not all consumers buy the same kind of merchandise in the same way. One man may buy a suit of clothes only after comparing the prices, qualities, and styles of several manufacturers. For him clothing is a shopping good. Another man may habitually buy a certain manufacturer's brand, and for him clothing is a specialty. One woman may shop for laundry equipment while another may have definitely decided to buy a certain brand. Hosiery may be a convenience good for one individual, a shopping good for another, and a specialty for a third.

Any one consumer's habit of buying and the dominant motives in buying are subject to constant change. An individual who shops for clothing may chance to buy a brand which pleases him and has such distinctive features that, thereafter, he may confine his purchases to the particular brand. For him, this brand of clothing has become a specialty. Furthermore, there are numerous commodities which are difficult to classify, being of a borderline nature. Besides, the habits of consumers as a group may undergo important changes. There is more of a tendency on the part of consumers to shop for groceries now than in the past, largely because of the automobile and the more frequent concentration of such stores at a single point. Thus a specialty good may in time become a convenience good, as illustrated by prepared baby foods which were first handled through drugstores and later through the grocery trade, or it may become a shopping good. The latter case is illustrated by the major electrical appliance market. When a new type of appliance is first developed, the number of competitive makes is naturally very limited, and each is likely to enjoy the advantage of being purchased as a specialty good. The Bendix automatic washing machine, for example, was the first appliance of this type and was originally sold entirely as a specialty good. When the product proved popular, other manufacturers of appliances entered the field. Now, with a number of nationally advertised and distributors' private brands of completely automatic washing machines, most customers make comparisons regarding prices, terms of sale, construction features, style, operation methods, and so on, before reaching a specific buying decision. Thus a given product may move from the shopping to the

specialty or to the convenience category, from the specialty category to that of convenience or from the convenience to the shopping classification, but very seldom from the convenience class to the specialty field. In spite of these reservations, the classification of consumer goods on the basis of consumer shopping habits as a whole is practical and useful and provides an excellent starting point in the solution of numerous complex marketing problems.

MARKETING FUNCTIONS

One of the best ways to obtain an appreciation of the nature and extent of the marketing task is through an understanding of the basic marketing functions that must be performed and which are the essence of the marketing process.

Marketing Functions Defined and Listed. *A marketing function may be defined as a major economic activity which is inherent in the marketing process, pervades it, and which, through a continuous division of labor, tends to become specialized.* In this sense a marketing function is not a technique, a tool, or a special activity that may be properly considered as but a part or phase of a function.

Some writers have proceeded inductively to list numerous detailed activities of middlemen which they call marketing functions. They have thus confused functions of middlemen with the marketing functions, even though some of the activities are not universal in their application or inevitable, and despite the fact that marketing functions are also being performed daily by farmers and manufacturers and also by consumers. Others have set down the numerous *activities* involved in marketing a given commodity and have labeled them marketing functions. This method, too, is subject to the objection that many of the activities in connection with a specific commodity are but part of a major marketing function or are not universally applicable.

For the sake of simplicity and clarity, the authors have confined their statement of functions to those *major activities that must be performed in the marketing of all goods*. These functions are:

1. Buying
2. Selling
3. Transportation
4. Storage
5. Standardization and grading
6. Financing
7. Risk-bearing
8. Marketing information

The first two of these functions are known as the *functions of exchange,* for they are directly concerned with the change in the ownership of goods. They are complementary in the sense that they are both involved in every transfer of title. For every sale there is a purchase and for every purchase there must be a sale. Transportation and storage are the *functions of physical supply,* both of them having to do with the actual, physical handling

of the goods incident to their movement from places of plenty to places of relative scarcity or to their storage from times of plenty to times of scarcity. The remaining functions, namely, standardization, financing, risk-bearing, and the collection and dissemination of marketing information, are *facilitating functions,* inasmuch as each of them aids in the performance of all of the other marketing functions.

To some critics it may appear that certain activities are not covered by the eight functions enumerated above. The so-called function of *assembling* goods in large quantities for economical shipment and handling or from different sources for the purpose of providing an assortment of merchandise may, upon closer analysis, well be considered but a part of the buying function. Similarly, the so-called function of *dividing* large quantities into the smaller amounts required by customers is but a small part of the selling function; while *packaging,* which is sometimes named as a separate marketing function, is often but coincidental to the function of grading and standardization and may at times even be regarded as a manufacturing rather than marketing operation. It is therefore believed that practically all activities of those engaged in marketing are embraced in the functions herein outlined.

Universality of Marketing Functions. The significance of the functional concept lies in the universality of the major activities that are recognized as functions. Buying involves on the part of the purchaser a determination of the kind, quality, and quantity of goods to be bought, and the choice of sellers from whom they are to be procured. From the standpoint of the businessman, it may require a concentration of a quantity of like goods or the assembling of a number of different items from hundreds of sources of supply for the convenience of customers.

Selling includes the seeking out of markets, influencing of demand through advertising and sales promotional effort, actual sales through salesmen and other means, and the servicing of the sales after they have been effected. Selling is especially important in a competitive society where, driven by a desire for profits, vendors take the initiative in promoting and satisfying the wants of consumers. That consumers also benefit from these efforts by sellers is shown in a later chapter.

Transportation is a marketing function which has greatly increased in relative importance in recent times. Even in the case of the simplest marketing mechanism, where the consumer buys directly from a local farm or factory, transportation is involved and must be performed either by buyer or seller. Such direct relationships are, however, not common. For example, the citrus fruit growers of Florida and California find their markets all over the United States and in Europe. Northwestern apples are sold in New York, Boston, and London. Hardware manufacturers of the eastern states

find good markets on the Pacific Coast, and the wheat of our Northwest has a world market.

The consumer is reluctant to anticipate his future needs for goods and cannot or will not provide storage for goods in quantity. He demands that supplies of goods be made accessible for satisfying his current wants. To meet these requirements marketing agencies must, in some way, provide for storage. One of the important services which the retailer performs is that of assembling and storing goods for the convenience of the consumer. Wholesalers find in the storage function one of the principal reasons for their existence. Back of the manufacturer, who also carries a stock of raw materials, goods in process, and finished goods, lies a marketing mechanism with many responsibilities in the storage of raw materials. Some storage is taken care of by the original producer on farms or at mines; further storage occurs at country points and in the cars in which the goods move to a central market.

Consumers generally prefer to purchase certain types of articles of uniform size and quality. Manufacturers, like consumers, have need for special grades of materials. The manufacturer of cotton yarn must have raw cotton of certain grades or qualities, depending upon the kind of yarn he expects to manufacture. Flour mills must have wheat of the grades which will permit the manufacture of flour of a certain uniform quality. But, on the other hand, no grower can produce oranges of a single size and quality. Oranges as they come from the grove vary in size and quality in any one season, and variable climatic factors may produce sharp differences in the qualities of one season's production as compared with another. Hence, standardization and grading become an essential marketing activity.

The consumer is accustomed to receive financial assistance in connection with his purchases. He may ask the seller to extend credit, and the assistance or service may take other forms. The retailer, even when the consumer pays cash, assumes the financial function through his investments in stocks of goods. If the retailer receives credit extensions from the wholesaler, the latter assists in financing the retailer's operations although, of course, the credit period granted by wholesalers does not as a rule relieve the retailer from the necessity of providing some market finance on his own account. Wholesalers in their turn receive certain financial assistance from manufacturers. Finally, in providing capital for credit extension and for making goods available through storage, the owned capital of merchants and manufacturers is augmented by assistance received from financial institutions such as commercial banks.

The owner of goods always assumes the risks of price changes. Other contingencies, too, may bring losses. Fires and floods may destroy goods, or they may be stolen. Customers may fail to pay for their merchandise and cause bad debt losses to sellers. Crop failures and industrial depressions

may curtail demand. Certain of these contingencies can be insured against, as, for example, in the case of the losses due to fire, flood, and theft. However, the premiums paid add to the costs of operating the business, and the indemnity paid by the insurer rarely compensates for all of the losses suffered. In a few trades, businessmen may minimize losses due to price changes in raw materials by resorting to hedging. In spite of hedging and modern insurance developments, there remain many market risks which must be borne by merchants and manufacturers, and the losses from which can be minimized only through the exercise of good business judgment.

The collection and dissemination of marketing information is a responsibility shared by consumers and all marketers. This responsibility may not seem to be a separate function but rather a responsibility covered fully by discussions on demand creation and buying. The collection and dissemination of marketing information involves, however, not merely the passive receipt or acceptance of information offered by sellers but active efforts to collect market news from other sources, such as governmental institutions and trade associations. Moreover, the collection of information would be of little value unless it is interpreted and disseminated with skill and intelligence. No small part of business success is attributed to the skill with which specialized marketing research departments and companies collect, analyze, and distribute factual information that serves as the basis for marketing decisions. Also, some marketing institutions such as brokers and resident buyers owe their existence, in large part, to their skill in obtaining, analyzing, and distributing information concerning sources of supply, prices and price trends, and other market conditions.

From the foregoing it is apparent that *marketing functions are indispensable and universal, regardless of the institution that may choose to perform them or the commodity in connection with which they may be performed.* They pervade the entire marketing process and are inescapable.

A certain institution, like the retailer or wholesaler, may be eliminated in the distribution of a given product; but the marketing functions remain nevertheless, and someone else will be forced to undertake their performance. The result of such a change may be to raise the costs of marketing or to lower them, depending upon the effectiveness and efficiency of the new agency that has assumed the functions. Be the cycle of distribution long or short, complex or simple, the functions of marketing essentially remain unaltered and inevitable.

Channels of Distribution

Still another method of judging the magnitude and complexity of the marketing task is by giving consideration to the multiplicity of channels through which goods move from production to consumption.

Channel of Distribution Defined. *The course taken in the transfer of title to a commodity constitutes its channel of distribution.* The title may be transferred directly, as when the commodity is bought or sold outright, or indirectly, as when the transaction is negotiated through a functional middleman such as an agent or broker who does not himself actually take title to it. It is the *route taken by the title to a product in its passage from its first owner,* the agricultural producer or manufacturer as the case may be, *to the last owner,* the ultimate consumer or the business user. The links in the channel or chain of distribution of necessity include both such owners inasmuch as they always participate to some extent in the marketing process.

Vertical Aspects of the Channel of Distribution. Normally, the channel of distribution is viewed vertically; that is, from the standpoint of the various *types* of links of which it is composed. It is concerned with the number of levels through which the title to goods is passed in the flow from source to final destination. For example, a manufacturer may elect to sell direct to consumers, or he may choose to utilize different types of middlemen who perform a variety of marketing functions at different stages in the flow of title transfer. The most common vertical variations in channels for consumer and industrial goods, respectively, are depicted in Figure 1.

The simplest channel is obviously that where manufacturers sell direct to consumers. This is sometimes accomplished by manufacturers who produce a wide line of related merchandise, the sales of which can support the operation of company-owned retail establishments. Stores operated by some manufacturers of paint or of men's clothing are illustrative. The same direct channel is used by manufacturers of articles that have qualities sufficiently distinctive to make possible mail-order sales. A third method of direct sale is through house-to-house salesmen. The Fuller Brush Company is illustrative of financially strong concerns which have adopted this method in order to achieve a high degree of control over personal selling effort.

A number of situations account for the manufacturer-retailer-consumer channel. Many manufacturers of men's and women's clothing sell direct to retailers, because the retailers handling such goods ordinarily purchase in fairly large quantities. This may be true because the stores are large, as in the case of department stores, or because they specialize in a limited line of merchandise. The channel is also used by manufacturers of perishable commodities. The meat packing industry is illustrative. In this industry, sale to retailers through company-owned branches is common because of the financial strength of the large producers and the special storage and handling requirements of the commodity. A less direct channel is to use agents or brokers to contact the retail trade. Such a channel is usually favored by small or specialized manufacturers who cannot afford to maintain their own sales organizations. Sales may be made more economically

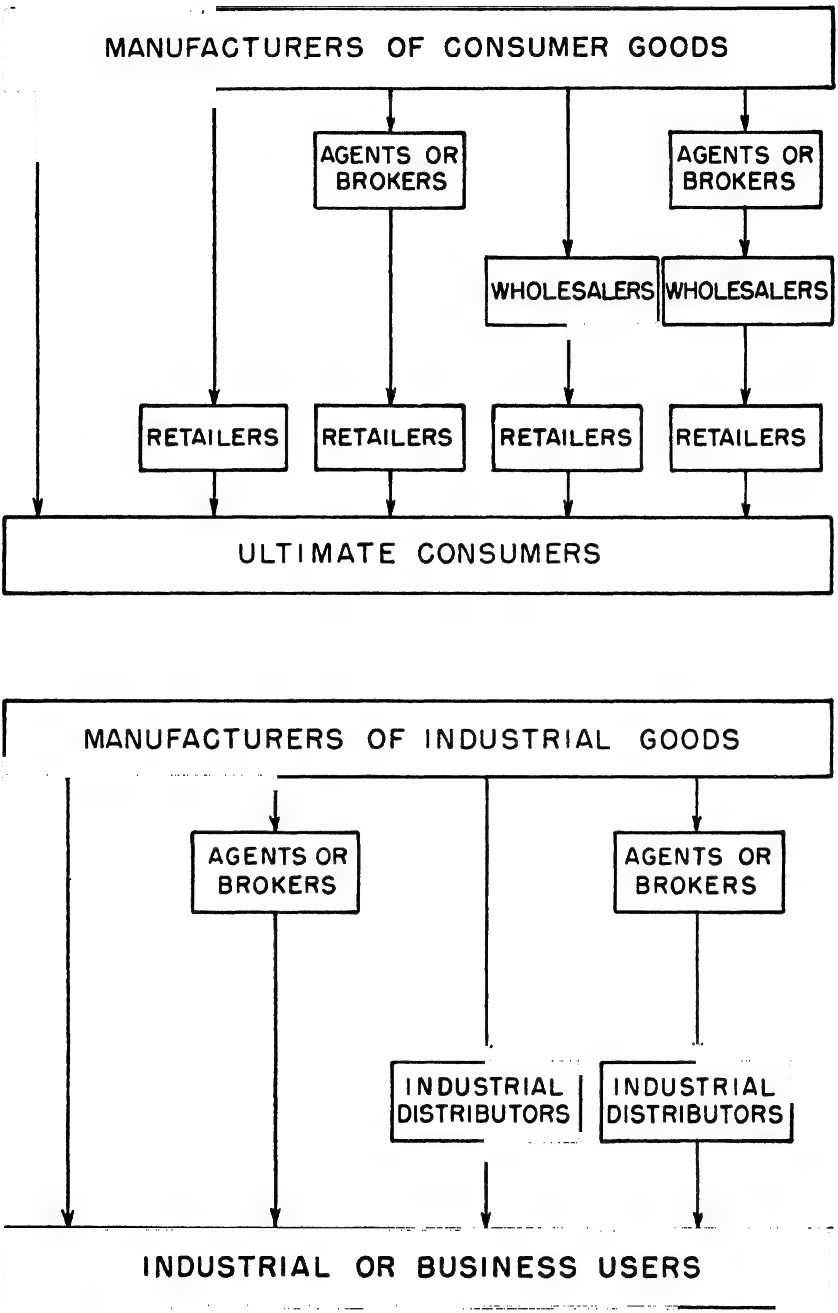

FIG. 1. Vertical aspects of channels of distribution, illustrating channels commonly used by manufacturers of consumer and industrial goods, respectively.

through agents or brokers because their costs of distribution are spread over the product lines of several manufacturers. This channel is generally used in contacting large retailing organizations, such as chain stores, department stores, and larger specialty stores.

The manufacturer-wholesaler-retailer-consumer channel is most common in the distribution of convenience goods to independent retail stores. Most manufacturers of tobacco, hardware, drugs, groceries, and other convenience goods have only a few products in their line of merchandise and cannot economically contact the thousands of retail stores needed for adequate distribution. Consequently, they call upon merchant wholesalers who stock merchandise and cultivate the entire retail market, even in the remotest regions of the country. Then there are numerous companies whose potential sales volume is so small or whose business is of such a seasonal nature that they cannot develop a sales organization to contact even wholesalers. The existence of such companies accounts in large measure for the use of agents and brokers who serve as substitutes for a manufacturer's own selling organization by negotiating sales with wholesalers. The canned fruit and vegetable industry, for example, numbers among its members many small manufacturers who dispose of their entire output through food brokers, who render a comparable service to other grocery product companies, including many flour millers and beet sugar refining companies.

In the marketing of business or industrial goods, direct manufacturer-user relationships are more common than is the case for consumer goods. Industrial installations usually involve sales of very high unit value and often require a factory-trained sales engineer for effective sale and service. Semi-manufactured goods such as sheet steel and parts, like motors for washing machines, are usually sold in large individual orders or contracts. Consequently, many manufacturers of such items are able to go direct to their customers. Producers of standardized equipment and tools of the type that are used in numerous factories often find it more economical to distribute through industrial wholesalers. Operating in a manner similar to the consumer goods wholesaler, but selling to industrial users rather than to retail stores, these organizations are to be found in all principal cities and are known in the trade by such terms as "industrial distributors," "mill supply houses," "equipment distributors," and so on. Short-line manufacturers of industrial goods often find it necessary to utilize the services of agents and brokers in making sales to the trade for the same reason that these functional middlemen are used in consumer goods marketing.

Marketing Establishments Operated by Integrated Firms. The charts in Figure 1 do not reveal an important matter relating to vertical phases of channels—namely, the position of marketing establishments that are owned and operated by integrated companies. Examples are manufacturer-owned

retail stores, manufacturer-owned wholesale branches, warehouses, or petroleum bulk tank distributing stations, and retailer-owned warehouses especially in the chain store merchandising field.

According to a strict interpretation of the definition of the term "channel of distribution," one may question the inclusion of such establishments in a discussion of channels. Actually, there is no *legal* transfer of title between the factory and the manufacturer-owned sales branch or retail store, nor is there any between the chain store warehouse and retail units in the same organization. Since, however, the census is taken on the basis of establishments and the information must be published for individual industries and lines of trade and by states and local areas, it is necessary that each reporting *unit* of a multiple-unit organization report as though it were operated as an independent establishment. That procedure is followed by the Bureau of the Census, even when goods are transferred from one plant of a manufacturing company to another for further processing; and while they are designated as "interplant transfers," they are viewed as in the nature of sales or shipments. Furthermore, manufacturers' wholesale branches and chain store warehouses operate similarly to independent wholesale establishments of the same character, and manufacturers' own retail stores operate similarly to independent or chain retail stores of the same type and character. *Functionally,* therefore, such establishments operating on the same level are fairly identical irrespective of differences in ownership. Failure to consider them as links in the chain of distribution would lead to confusion when comparing one channel with another or in comparing costs of distributing through alternative channels. From a practical standpoint, therefore, transfers of goods to different kinds of establishments within an integrated company must be considered in the nature of sales.

Horizontal Aspects of the Channel of Distribution. The channel-of-distribution problem is much more complex than has been indicated in the foregoing discussion. Despite the fact that a channel of distribution is normally considered only from a vertical dimension viewpoint, many manufacturers also have important alternatives to consider with regard to the *horizontal* aspects of different levels in the channel. On any given level (wholesale or retail) there are many different kinds of establishments when classified by line of goods handled or by method of operation.

Although the situation varies considerably from one line of goods to another, the character of the problem may be illustrated with an example. Prepared baby foods were originally marketed as specialty goods and were sold chiefly through drugstores, because they were purchased by mothers upon the advice of pediatricians or general medical practitioners who prescribed feeding programs for babies. When the first mass producer of such goods began to sell them through the grocery trade, a different channel was

used even though it may have comprised the same types of links. More recently, this was illustrated by the change made by another manufacturer of such items who primarily produced drug merchandise and hence found it natural to sell also the few baby food items through such line of business. This manufacturer originally distributed these products through wholesale drug firms who, in turn, sold them to the retail drug trade. As such products became more widespread in use, they were purchased by the housewife as convenience goods and mostly in retail grocery outlets. Because wholesale druggists did not have contact with retail grocery outlets, many wholesale grocers purchased the products from wholesale druggists and in this unnatural manner the items eventually found their way to the retail grocer. In the years following World War II, the marketing pattern had changed to such an extent that about 85 per cent of total consumer purchases of these baby foods were being made from grocery stores. When this was recognized by the manufacturer, a decision was made to simplify the channel of distribution by making the product directly available to wholesale grocery organizations.

This change was fraught with real significance. National distribution was formerly accomplished by direct dealings at the most with only about 300 wholesale drug firms. Wholesale grocers, however, are much more numerous. It would be essential to contact at least about 3,000 such firms to provide dense nation-wide coverage among retail grocery outlets. This called for basic marketing changes in the manufacturing company. Since it was not considered feasible or economical for the manufacturer to expand his own sales organization to the extent necessary to handle such a large number of channel contacts, food brokers were employed to sell the products from the manufacturer to wholesale grocery organizations. Thus, a decision to modify the channel horizontally on the wholesale level, by shifting from drug wholesalers to grocery wholesalers, was a channel problem of very great importance. It is felt that even in the absence of the introduction of brokers, the change from drug to grocery wholesale outlets was of sufficient significance market-wise to constitute a change in the channel of distribution.

Horizontal modifications of channels have become increasingly important. In former decades, it was rather common to find that there was a single natural channel for many kinds of commodities. Especially since World War II, however, there has been considerable diversification of merchandise lines by many kinds of stores on the retail level. Many drug items, toilet goods, and housewares are now sold in food stores, especially of the supermarket type. The modern large drugstore sells many items of general merchandise not formerly part of drugstore retailing. Many automobile accessory stores have become rather complete hard-line stores, handling all kinds of household appliances, hardware, lawn and garden supplies,

and housewares. Such changes, sometimes popularly described as "scrambled merchandising," have forced an increase in the complexity of the horizontal aspects of many manufacturers' distribution efforts.

Other Channel Variations. There are additional reasons which complicate the channel question. Many manufacturers find it necessary or desirable to use more than one kind of channel (in the vertical sense) for the same product. This is particularly true of commodities which have a double market. Automotive tires are an important example. That portion of the industry's output which is sold for original equipment on new cars is distributed direct from tire factories to automobile manufacturers. Tires for replacement equipment on cars on the road are sold principally through manufacturers' branches to retailers, or through regular wholesalers to retailers. Some manufacturers have different products that require separate distribution channels. Illustrative is the meat packing industry. In addition to meat sales to retail stores, the industry is confronted with the problems of selling numerous types of by-products to different classes of customers, each of which poses a special channel-selection problem. Finally, some manufacturers find it feasible to use different channels in different parts of the country. Many manufacturers of factory machinery and store equipment sell direct to industrial consumers in regions where customers are highly concentrated but rely on manufacturers' agents for effecting sales in those areas where potential customers are widely scattered.

The foregoing discussion has been concerned with the distribution of manufactured goods. Channels for agricultural commodities involve a greater multiplicity of types of middlemen. Distribution of such goods is more complicated, because they come from large numbers of small producers. In local growers' markets, various types of assembling middlemen are found. These include independent cash buyers of farm products, trucker-buyers, and the assembling agencies of cooperative marketing associations. Then there are also unique types of concentrating agencies in the major city wholesale markets. Of particular importance are the fruit and vegetable auctions found in a number of our leading cities.

Selection of Trade Channels. The importance of the proper selection of channels of distribution cannot be overemphasized. Every manufacturer of consumer goods is faced with the question as to whether he shall sell to wholesalers or whether he shall go direct to retailers or even to the ultimate consumers. In the marketing of industrial goods he is faced with the question as to whether he shall go direct to the mills, mines, quarries, and other consumers or whether he shall distribute through supply houses. In the marketing of all kinds of goods he is further faced with the problem of selling through his own sales force to either of the above or of employing the

services of a functional middleman. Even when he has decided to employ functional middlemen, the question arises as to which of the various types of functional middlemen—brokers, manufacturers' agents, selling agents, commission houses, etc.—will best serve his purpose and prove most efficient and most economical. He is also faced with the problem of determining whether one channel will suffice, or whether two or more different channels are required for the distribution of his goods because of differences in the products made or markets served. Finally, he must decide upon the kinds of business or lines of trade through which his goods should move, which will, in turn, determine not only the types of links to be used but the number of links. Cases abound where such decisions have been reached in a haphazard manner and much to the detriment of the producer. To approach this problem scientifically it is essential that we know how various goods are being distributed, and what factors govern the choice of given channels.

Policies of different vendors in the choice of trade channels vary widely. Instead of centering such discussions in a single chapter, the authors have deemed it best to analyze and discuss such policies in connection with the treatment of each important marketing institution. This approach tends to make the presentation of marketing institutions more complete and rounded and gives the study of trade channels a more realistic setting.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   - *a*) macro-economics
   - *b*) micro-economics
   - *c*) marketing function
   - *d*) channel of distribution
   - *e*) vertical aspects of channels
   - *f*) horizontal aspects of channels
2. Has employment in marketing increased or decreased, in the long run, relative to employment in the production of commodities? Why?
3. In the publications of the U. S. Census of Manufactures, data have been reported for many years for "value added by manufacture." Similar data have never been compiled in the U. S. Census of Business for marketing establishments. Can you see any reason for collecting and publishing such information for one sector of our economy and not for another? Would such variation in treatment give rise to differences in interpreting the economic significance of costs which are incurred in manufacturing and which are incurred in marketing establishments? Explain.
4. What criteria have been utilized in developing the basic classifications for goods, as presented in this text? What marketing significance is associated with each criterion? Explain.
5. How can you explain the fact that the volume of trade transacted in the United States is much larger than consumer expenditures for goods and services?

6. Give several examples of products that are both consumer and industrial goods. Give several examples of goods that are both supplies and raw materials.
7. What determines the classification of a consumer good, and does such good necessarily always remain in the same classification?
8. State the most important characteristics of convenience goods, shopping goods, and specialty goods. Explain how these characteristics are related to the problem of selecting channels of distribution.
9. Classify each of the following into convenience, shopping, or specialty goods:

   a) cigarettes
   b) sugar
   c) soap
   d) dresses
   e) automobile tires
   f) millinery
   g) men's suits
   h) jewelry
   i) women's hosiery
   j) electric washing machines
   k) refrigerators
   l) books
   m) eyeglasses
   n) furniture

10. Is the term "marketing function" as used in the text synonymous with the term "marketing activity"? Explain.
11. What are the functions of exchange, the functions of physical supply, the facilitating functions?
12. Transportation is a function of marketing. One of the marketing functions is transportation. Which of these statements is correct and why?
13. What is meant by the term "channel of distribution"? Is this primarily related to the *physical* distribution of commodities? Are manufacturer-owned wholesale sales branches or retail stores a part of the channel? Explain.
14. Is there a *most* efficient channel of distribution for a given commodity? If so, then why is it that there is usually more than one channel of distribution being used for each commodity marketed?
15. If you were a manufacturer of convenience goods and possessed a limited amount of capital, which channels of distribution would you consider? Why?
16. When chain store organizations eliminate wholesalers from the channel of distribution and buy directly from manufacturers, what marketing functions are eliminated? Explain.
17. What data are available which indicate the vastness of the marketing structure? Is there any good reason for considering service establishments as a part of the marketing structure for *tangible* commodities? Explain.

II

THE ULTIMATE CONSUMER

3

POPULATION FACTORS AND CONSUMPTION

In Part II of this book, consideration is given to the prominent role that the ultimate consumer occupies not only in our marketing system but in the entire economic order as well. *Consumption is the satisfaction of human wants through the destruction of the utilities embodied in goods and services.* Generally, it is a passive function. People do not ordinarily come into the markets and demand goods or services concerning which they have little or no knowledge, nor do they demand changes which they are unable to conceive. Instead, ingenious producers and distributors present new or different commodities and services to consumers for appraisal; but the wishes of the consumers as expressed through the consumer-buyers are, in the final analysis, controlling—hence the expressions to the effect that "the consumer is king" or that "the consumer is the court of last resort." This is certainly true to the extent that the consumer accepts or rejects what the businessman offers. Consumer-buyers in the aggregate are members of a nation-wide jury; they are the voters in the market place; at least in the long run they are the ultimate controllers of both the goods which will be offered for sale and of the methods used by sellers in marketing them. Thus, their votes and decisions cannot be long ignored without disastrous consequences.

Ultimate Consumers Distinguished from Industrial Users. Because of essential dissimilarities governing the buying, and hence also the selling, process, ultimate consumers must be distinguished from business or industrial users of commodities. *Ultimate consumers* are the millions of persons who buy goods for personal or family use or for household consumption. Sales to such consumers are normally made by retail stores and, to a relatively much smaller extent, by direct-selling farmers or manufacturers. Goods

so purchased by consumer-buyers include food, wearing apparel, household furnishings, automotive goods, recreational services and supplies, and all other items that are used for personal gratification, rather than for business purposes.

Industrial users (sometimes called industrial consumers) are those who purchase goods and services for use in manufacturing establishments, offices, retail stores, wholesale houses, service businesses, financial organizations, private and governmental institutions, and others who buy for business purposes which may be conducted on a profit or nonprofit basis. Such goods consist *largely* of raw materials, semi-manufactured commodities, parts, machinery, equipment, and supplies. They are purchased not for the satisfaction which follows personal consumption by the buyer, but to facilitate the performance of manufacturing, distributive, and institutional functions. Because of these reasons, the buying motives and factors affecting the use of *business* goods differ from those that govern the purchase of goods by ultimate consumers and are therefore treated separately in Chapter 17 of this text.

Consumer-Minded Marketing Management. While manufacturers and distributors can do much to stimulate, modify, and direct consumer demand, they can do little to make their commodities salable unless they are adapted to the needs of consumers. Growing recognition of this principle has led those engaged in marketing management to orient their thinking toward consumption.

Markets for consumer goods may be regarded as consisting of people who have needs and wants and who have the buying power to express their wants in terms of effective demand for goods and services. Stimulating, altering, and directing consumer demand is accomplished largely through advertising and personal salesmanship. Efforts to accomplish this may be altogether fruitless, very costly, or relatively efficient, depending upon whether products actually have the characteristics or capacities to satisfy the wants of consumers and whether the appeals used in marketing the products strike a responsive chord with a large segment of the consuming groups to which they are directed.

For efficient performance of the task, marketing organizations must understand the people that make up the population, their wants, the motivations of consumer-buyers, the purchasing power of consumers, and certain other important factors that affect consumption. This line of reasoning explains the pattern of organization which has been adopted for Part II. First, attention is given to population and its characteristics in relation to consumption. Second, in Chapter 4, consideration is given to the needs and wants of consumers, especially in the role of consumer-buyers, and to an understanding of the motivating factors that explain why such buyers are

likely to want some products in preference to others or to patronize certain marketing institutions in preference to alternative establishments. Finally, in Chapters 5 and 6, attention is centered upon buying power and the manner in which variations in it are related to the demand for different kinds of goods and services, as well as to certain other factors such as fashion, which exert an important influence upon consumption. This whole analysis sets the stage, so to speak, for a proper understanding of the study of marketing institutions and functions which are treated in subsequent parts of the book.

Population Factors[1]

The Total Population. Of very great significance to the marketer of consumer goods which are in widespread demand are the magnitude of and changes in the *total* population of the country, for it is the wants of *all* the people that the economy attempts to satisfy. After all, all our people are ultimate consumers of what they themselves produce for their own use and of what they buy. It is therefore important to know who these people are and all essential characteristics concerning them including significant changes therein.

Several series of data pertaining to the total population and its major characteristics during the course of this century are presented in Table 1. Here it is shown, first, that our economy has been characterized by a rapidly expanding population. Over a period of little more than a half-century, the total population more than doubled, increasing from 76 millions in 1900 to 167 millions by the end of 1955. Between the decennial censuses for 1940 and 1950, the increase was 19 million persons or 14.4 per cent and in the next *five* years a relatively greater increase of about 16 millions or 10.6 per cent was experienced. Population authorities are in general agreement that the country will continue to experience great population growth which may, other things being equal, open huge future potential markets. Even if the fertility rate should decline to pre-World War II levels, the total population should substantially exceed 200 millions by 1975. If, however, the high fertility rate of the 1954–1955 period should continue, the expected 1975 population would approach the 230 million mark. If one takes a middle ground between these extremes, it is apparent that between 1955 and 1975 the total population will increase by over one-fourth.

It has often been assumed, especially in economic prognostications in the more popular business journals, that the projected rapid population growth is a major causal factor that automatically produces increasingly prosperous business conditions. This is a gross oversimplification of an exceedingly complex problem. Population growth does not, in itself, create

[1] Unless otherwise specified, all population data used in this chapter are taken directly or adapted from official publications of the U. S. Bureau of the Census.

TABLE 1

CHARACTERISTICS OF THE POPULATION OF CONTINENTAL UNITED STATES, BY DECADES, 1900–1950, AND 1955

	1900	1910	1920	1930	1940	1950	1955
Total population (millions of inhabitants)	76.0	92.0	105.7	122.8	131.7	150.7	166.5
Per cent of total population in specified age groups:							
Under 15 years	34.4%	32.1%	31.8%	29.4%	25.0%	27.2%	29.5%
15-44 years	47.6	48.9	47.3	47.7	48.3	44.6	41.8
45-64 years	13.7	14.5	16.1	17.4	19.8	20.6	20.2
65 years and over	4.3	4.5	4.8	5.5	6.9	7.6	8.5
Median age of the total population	22.9	24.1	25.3	26.5	29.0	29.8	30.5
Per cent of total population residing in urban and rural areas:							
Urban (places of more than 2,500 inhabitants)	39.7%	45.7%	51.2%	56.2%	56.5%	58.4%	64.1%
Rural (farms and places of less than 2,500 inhabitants)	60.3	54.3	48.8	43.8	43.5	41.6	35.9
Per cent of total population residing in each geographic region:*							
New England States	7.4%	7.1%	7.0%	6.7%	6.4%	6.2%	6.1%
Middle Atlantic States	20.4	21.0	21.1	21.4	20.9	20.0	19.9
East North Central States	21.1	19.8	20.3	20.6	20.2	20.2	20.4
West North Central States	13.6	12.6	11.9	10.8	10.3	9.3	9.0
South Atlantic States	13.6	13.3	13.2	12.8	13.5	14.1	14.1
East South Central States	10.0	9.1	8.4	8.1	8.2	7.6	7.0
West South Central States	8.5	9.6	9.7	9.9	10.0	9.6	9.4
Mountain States	2.2	2.9	3.1	3.0	3.2	3.4	3.6
Pacific States	3.2	4.6	5.3	6.7	7.3	9.6	10.5
Total number of families (millions)	16.0	20.3	24.4	29.9	34.9	39.3	41.9
Average size of family (number of persons)	4.7	4.5	4.3	4.1	3.8	3.7	3.6

* States are included in each region as follows: *New England,* Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut; *Middle Atlantic,* New York, Pennsylvania, New Jersey; *East North Central,* Ohio, Indiana, Illinois, Michigan, Wisconsin; *West North Central,* Minnesota, Iowa, Missouri, North Dakota, South Dakota, Nebraska, Kansas; *South Atlantic,* Delaware, Maryland, District of Columbia, Virginia, West Virginia, North Carolina, South Carolina, Georgia, Florida; *East South Central,* Kentucky, Tennessee, Alabama, Mississippi; *West South Central,* Arkansas, Louisiana, Oklahoma, Texas; *Mountain,* Montana, Idaho, Wyoming, Colorado, New Mexico, Arizona, Utah, Nevada; *Pacific,* Washington, Oregon, California.

Source: Various Census publications on population, including "Provisional Estimates of the Population of States, July 1, 1955," Series P-25, No. 129, January 20, 1956, and U. S. Department of Commerce, *Historical Statistics of the United States, 1789–1945* (Washington, D. C.: Government Printing Office, 1950), pp. 25–29.

either new markets or the means of supplying them.[2] This is clearly evident from experience in many foreign countries, most notably in Asia, in which there is both increasing population growth and increasing poverty. Population expansion can be associated with rising prosperity only under conditions where *real* per capita income increases at the same rate or at a rate greater than the increase in the number of people. Under any other circumstance, the only possible consequence is a lower level of real per capita consumption.

[2] For a very comprehensive treatment of this thesis, see Joseph J. Spengler, "Population Threatens Prosperity," *Harvard Business Review,* January–February, 1956, pp. 85–94.

Regardless of the eventual economic consequences of population trends, the total population at any given time spells the total number of *ultimate consumers*. This must not, however, be confused with the total number of *consumer-buyers*. The family rather than the individual must be considered as the consuming unit for many products. For articles of family use, the housewife is usually the sole or principal purchaser. She certainly exerts the dominant influence in the determination of wants and the decision of what and when to buy articles of home furnishings, housewares, children's apparel, and even a considerable proportion of men's furnishings. In such decisions she is, to be sure, indirectly influenced by her interpretations of the wants of the other members of the family. This means that a considerable proportion of the total population (e.g., babies and small children) is without direct influence in the buying process, except as its wants are interpreted by consumer-buyers (e.g., mothers), and to a considerable extent it is also true of other parts of the population.

While changes in the total population are of great importance as a reflection of the total potential demand for goods and services, very few items are demanded equally by all types of persons. Accordingly, knowledge of the changing characteristics of the population are of crucial significance. Among the more determinative population characteristics are size of families, age distribution, geographic distribution, urbanization and suburban living, population mobility, and the status of women as the major consumer-buyers in the economy.

Size of Family. Family size has an important bearing upon living standards and the character of consumption. Small families may maintain a fairly high living standard on an income which would support only a relatively low standard for a family with a large number of dependents. Over the course of this century to about 1950, the average size of family tended to decrease. This trend, together with rising personal income levels, contributed to marked expansions in markets for education, health services, and recreation, since the small family needs to spend less of its income for food, housing, and other necessities and has more to spend for the miscellaneous items just mentioned.

The reduction in the numbers of dependent children per family led to the substitution of apartments and small houses for the larger homes formerly in demand. This, in turn, affected the market for furniture and house furnishings from both the quantitative and qualitative points of view. Apartment house dwellers wanted less furniture and, since they moved frequently, it had to be less bulky than the products which were demanded by earlier generations. As the economic status of the average family improved by a reduction in the number of dependents, furniture demand took on a quality character.

The trend until about 1950 toward smaller families had an important influence upon marketing. Since that time there have been significant indications of a possible reversal of the long-term trend. In the years 1954–1955, for example, the birth rate was at an all-time high level. This was reflected not only by births of first children in new families, but also by births of second, third, and fourth children in a family. For example, in 1954 the number of first children born into families was only 47 per cent greater than in 1940, but the number of second and third babies within families was 91 per cent and 86 per cent, respectively, higher than in 1940. Unprecedented levels of high average family income, together with a continuing favorable economic outlook, have undoubtedly contributed to this situation.

The recent trend toward larger families has brought with it a changing character of demand. Infants' and children's stores have prospered, as well as those selling toys and games. By 1955 many families that were started in the post-World War II years of 1946–1947 had outgrown their small homes or apartments, and this resulted in a greatly increased demand for three- and four-bedroom residences and the necessary furnishings for them.

Composition by Age Groups. Many variations in consumption are explained by a changing composition of the population with respect to age groups, as reflected in the data in Table 1 and Figure 2. In the early part

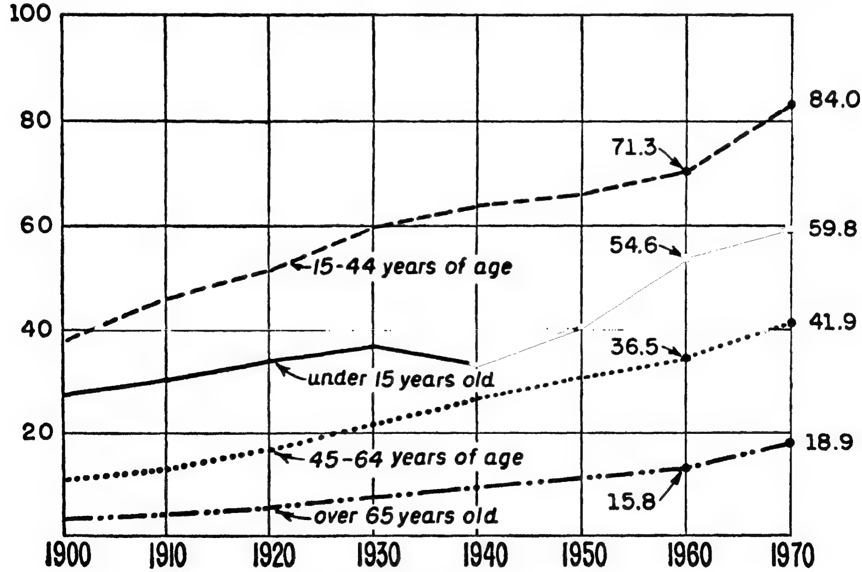

FIG. 2. Distribution of the population by age groups by decades, United States, 1900–1970 (millions of inhabitants).

Source: Bureau of the Census publications. (Data for 1960 and 1970 are projections based on the assumption, for persons not born prior to July 1, 1955, of a continuation of the 1950–1953 level of fertility.)

of this century the United States was a nation of youth. More than one-third of the population was under 15 years of age in 1900, but this proportion declined to one-fourth by 1940. Since that time it increased to about 30 per cent in 1955 because of the high birth rates in the decade following World War II.

Over a long period of years, the death rate has been steadily declining, due, in large measure, to a decline in infant mortality, better balanced and more adequate diets, improved medical care, and greater control of certain infectious and contagious diseases. As a consequence, the proportion of the population over 65 years of age doubled between 1900 and 1955, giving the entire population a more mature character. This has resulted in increased demand for goods and services especially wanted by or suited to the aged. Because older people are particularly prone to sickness, accidents, and other disabilities, manufacturers and distributors of certain drugs and medicinal preparations and disability devices like eyeglasses and hearing aids have experienced expanding markets. Many of the aged are not able to provide for their own economic support. As a result, material aid for their benefit has become recognized as a public responsibility. Governmental and industry-sponsored pension plans are providing a constantly widening stream of fixed income, and this helps to stabilize the purchasing power of the population.[3]

Because most of the people who will be living ten, twenty, or thirty years hence have already been born, many characteristics of future consumption demand have already been charted. The number of people of any given age is generally closely related to the birth rate in some preceding year. Year-to-year changes in the birth rate result in numerous internal shifts in population composition. For example, the previously unequalled number of 3.7 million births in 1947, followed by more than 3.5 million births in each of the two succeeding years, was accompanied by an unprecedented demand for infant layettes in those years and by a similar demand for shoes for three-year-old children in 1950. The even greater birth rates of a prolific population in some of the succeeding years has continued to expand markets for such products.

The impact of the post-World War II "baby bulge" in the population was felt in the elementary school system in the early 1950's, as the babies became children, giving rise to greater needs for grade school equipment, textbooks, and supplies. The same wave will reach the high schools in the early 1960's and the colleges in the middle 1960's, with attendant benefits to manufacturers and retailers of teen-age and junior sizes of apparel. Similarly, the abnormally low birth rates in the serious depression years

[3] For a comprehensive treatment of this subject, see "Marketing and Gerontology" by James A. Brunner, an unpublished doctoral dissertation at the Ohio State University, 1955.

of the 1930's resulted in a situation where there was an unusually low number of teen-agers in the population during the late 1940's, and it also indicates a decline in the number of persons between the ages 20 and 24 between 1950 and 1960. On the other hand, the post-World War II infants will be entering the labor market, marrying, and starting families in the years 1965–1970. This, again, other things being equal, should give rise to unparalleled demands for housing and home furnishings in those years.

Something of the course of future trends by broad age groups is indicated by the projections in Figure 2. Manufacturers and distributors of specific products that are related to the wants of particular age groups study these more detailed breakdowns of data in order to anticipate the probable future effects of this important factor upon consumption.

One aspect of the composition of the population by age groups presents an interesting challenge to technology. As has been indicated previously, rapid increases in the total population of the United States have been associated with an increasing fertility on the one hand, and a declining death rate at all ages on the other. In the short run, then, the younger and older segments of the population tend to increase at a rate much more rapid than the middle segments, thereby reducing the proportion included in the labor force. In other words, the structure of the population changes in a manner that results in an increase in the ratio of dependent persons to persons in productive years of life. In order that living standards be maintained or raised for the average person, there is a compelling requirement to increase the productivity of persons in the labor force so as to offset the declining ratio of the labor force to the total population.

Geographic Distribution of the Population. An important prerequisite to the effective analysis of national markets is knowledge concerning the geographic dispersion of the population and the constantly occurring shifts in it among the various regions of the country. This may lead in many instances to a segmentation of the national market for effective cultivation. Data showing the percentage distribution of the total population by decades in nine geographic regions are given in Table 1.

During the course of this century, population growth in the New England, North Central, and the Southern states along the eastern seaboard has failed to keep pace with the national trend. The result is a declining *proportion* of the total population in each of these areas. On the other hand, migrations from one region to another have accounted for very substantial increases in the proportion residing in the West South Central, Mountain, and Pacific states. These shifts are not only related to the distribution of market potentials for products which are in widespread use everywhere, but are also of great significance in explaining changes in the total consumption picture for products that are related to climatic differences and the varying cultural and social patterns in the several regions.

California, Florida, and Texas are three of the states experiencing very large population increases as a result of migrations from other states. The warmer climate and more leisurely life in these areas have been important factors contributing to the greater effort for comfortable and colorful sportswear. Examples of other products affected by regional population shifts are too numerous to permit detailed discussion. Illustrative of a few are convertible automobiles, sunglasses, gas floor heaters for installation in homes not requiring central heating plants, and men's lightweight topcoats.

Rural–Urban Migration. Originally and for many years the inhabitants of the United States were primarily an agricultural people. For some decades past, there has been a steady decline in the percentage of people living on farms and in rural areas (see Table 1). At the present time only about 12 per cent of the total number of families actually lives on farms; nearly 60 per cent of the total population resides in cities of more than 2,500 people; the remainder lives in rural nonfarm communities.

This trend in the distribution of the population has important marketing consequences. Mechanization of agriculture has been the important factor contributing to a declining farm population, a decline in mass farm markets, and a drastic alteration in the pattern of consumer demand originating on the remaining farms. Our cities, housing the majority of the population, are market places where more than three-fourths of the total retail trade in the country is transacted. Although rural dwellers make numerous visits to cities, it is the urban population that constitutes the dominant market for consumer goods.

Suburban Living. One of the most significant population developments has been the increase in suburban living. Between 1940 and 1955, population increases in the suburban or outlying regions of the country's major metropolitan areas have been four to five times as great as population growth in the central cities. This movement has been accompanied by substantial increases in home ownership. Over the period 1900 to 1940, the proportion of families owning their homes was relatively stable at about 40 per cent of the total. By the time of the 1950 Census of Population, home ownership had increased to about 55 per cent, and various real estate authorities estimated that 60 per cent of American families were living in their own homes in 1955.

Home ownership, suburban living, and attention to family life have brought many changes in consumption patterns. Less interest in spectator amusements has been accompanied by increased expenditures for television, phonographs and records, magazines and books. Demand for many kinds of products has multiplied many times. Illustrative are porch and lawn furniture, power lawnmowers, garden tools and supplies, outdoor cooking

equipment, and second family cars. This trend has also accounted for the development of large, planned suburban shopping centers.

Population Mobility. In many foreign countries, it is common to find members of the same family living in the same home over the course of several generations. The United States is in marked contrast with respect to mobility. In *each* of the years since World War II, about 20 per cent of our families have moved from one place of residence to another. Of the total movers, about two-thirds change to another residence in the same county, about one-sixth to another residence in some other county in the same state, and about one-sixth to another residence in another state. Over a period of years the cumulative effects are striking. They account in large measure for the changing geographic pattern of population distribution, for the rural to urban migration trend, and for the trend to suburban living. A family that moves is likely to have different expenditure patterns during the year than a nonmoving family. In addition to moving expenses, there are usually requirements for new home furniture or household equipment. It has been found that the proportion of movers making major durable goods purchases in a year is nearly 50 per cent greater than the proportion for nonmovers.[4] Population mobility has also accounted for the development of a large market for house trailers. Many of these are occupied by families of construction workers and others engaged in seasonal or other temporary types of employment, by retired persons or other itinerants who desire to move their own home with them, and by those who find the idea of living in a modern home trailer more economical or more appealing than in a home or apartment.

Status of Women in the Economy as Related to Marketing

Improvements in the economic and social status of women are matters of great marketing significance. Many changing consumption patterns are explained in part by the employment of women, the increase in their interests outside the home, and their outstanding role as purchasers.

Employment of Women. The number and percentage of women, both single and married, who are gainfully employed has increased greatly during the first half of this century. In 1900, only about 17 per cent of the total labor force consisted of women, and of the women who were employed at that time, less than one-sixth were married. By 1950, almost 30 per cent of

[4] In 1952, 62 per cent of the movers included in the sample of families in the Survey of Consumer Finances made major durable goods purchases whereas the proportion for nonmovers was only 46 per cent. L. R. Klein and J. B. Lansing, "Decisions to Purchase Consumer Durable Goods," *The Journal of Marketing*, October, 1955, p. 111.

those in the civilian labor force were women, and more than one-half were married. Of the total number of women in the labor force, 60 per cent were employed full time or nearly full time (over 35 hours per week), and about 40 per cent were engaged in part-time work or were employed only at particular seasons of the year. About eight out of ten single women, no longer in school, are ordinarily holding jobs or are seeking work. Among recently married couples, about one-half of the wives are in the labor force; but after ten years of marriage, only about two out of ten work, as the remainder are caring for children. The proportion rises again among women who have been married a longer number of years, because many mothers go back to work after their children are old enough to care for themselves.

Increasing employment of women has greatly affected marketing. The resulting increase in family incomes has done much to raise standards of living and has stimulated the demand for clothing, education, recreation, investments, and luxury items. Pressure on the energies of women employed outside the home has helped to create a large market for labor-saving household devices, ready-made clothing, and prepared foods. On the other hand, it is obvious that mechanical advancement has led to the transfer of many occupations from home to the factory. The gainful employment of women has, therefore, been due in part to the release of energies from former household tasks.

Women as Purchasers. The improvement in the economic status of women due to gainful employment and the related improvement in their political and social condition has placed a large share of the total purchasing power at their disposition. When we were predominantly an agricultural people and few women were employed outside the home, the bulk of the family purchases was made by men. Today, it is common for marketing executives to think of the housewife as the purchasing agent for the family. In the great majority of families women are responsible for the bulk of the family purchases. They buy clothing for themselves and for the children, as well as the food, housewares, home furnishings, and even much of the clothing worn by their husbands. To be sure, the housewife is influenced by the needs and wants of other members of the family and interprets these as she makes buying decisions. This explains the very considerable amount of advertising directed to children as, for example, in television programs with a juvenile appeal. The advertiser employs this strategy in some instances in the knowledge that children can become quite vociferous in the expression of their wants, which are taken into account by the housewife in planning family purchases.

It is generally recognized that women exert a profound influence in the purchase of much merchandise even though the actual buying may be done by men. It is doubtful if many passenger automobiles are purchased with-

out a woman's influence being reflected in the choice of body design, color, and interior appointments. The manufacturer and merchant of today must realize the importance of the woman purchaser and her far-reaching influence in the selection of goods and services. Merchandise must appeal to women, publicity must be adapted to their motivation, and the place of sale and the accompanying service must be adjusted to their needs, whims, and fancies. The development of the department store, peculiarly a woman's institution, is evidence of the importance of women as purchasers.

Whether men or women are the usual purchasers of a given product is a question of great importance to the marketing executive. Numerous scientific studies conducted by experimental psychologists have revealed that there are important differences between the sexes with respect to purchasing activity and reaction to advertising and selling appeals. Generally, but not in all individual cases, women are more interested in social situations and conventions, have stronger likes and dislikes, have a slower association and perception time, are more inclined toward introversion, are more open to suggestion, and are less self-sufficient and less dominant than men.[5] The knowledge that these differences generally prevail has led to numerous consumer research studies, the purpose of which is to determine which member of the family usually buys a given product and the degree to which the purchaser is influenced by other members of the family in reaching buying decisions.

Conclusion. In this chapter attention has been centered upon total consumers and certain of their group attributes as reflected by various population characteristics. That there are other important population factors which have a bearing upon consumer demand goes almost without stating. Illustrative is the increasing educational level of the population, which explains our wide newspaper and magazine circulation. Another is the growth of leisure time as a result of a shortening work-day, a contracting work-week, the development of household labor-saving and time-saving devices, and faster means of transportation. All of these have contributed, for example, to increased demand for recreational goods and services.

One conclusion to be drawn from this discussion is that a knowledge of demography, sociology, psychology, and related fields contributes much to understanding consumption in our modern society. Much, however, still remains to be explained. Consequently, the three following chapters are to be regarded as a continuation of the discussion which was introduced in this chapter.

[5] For a detailed analysis of the contributions of studies by experimental psychologists on the marketing implications of sex differences, and a bibliography of 145 books, pamphlets, and journal articles on this subject, see R. S. Alexander, "Some Aspects of Sex Differences in Relation to Marketing," *The Journal of Marketing,* October, 1947, pp. 158–72.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   a) consumption
   b) ultimate consumer
   c) business or industrial user
   d) consumer-buyer
2. What is meant by consumer-minded marketing management? Is this more or less essential now as compared with former decades? Explain.
3. How would a knowledge of current population characteristics aid in estimating the probable demand for housing or home furnishings in the year 1970? Explain.
4. In what ways has the modern trend for suburban living affected consumption patterns? Explain.
5. What has been the trend in the employment of women in the United States? Why is this information of significance to a marketing executive?
6. How does education affect the buying habits of consumers?
7. Are geographic differences in consumption and purchasing habits as great today as they were 50 years ago? Explain.
8. Of what significance to the department store is the increasing proportion of older people?
9. The year 1948 was extremely prosperous. Total output of goods and services reached hitherto unprecedented levels. Total retail sales and department store sales were at an all-time high. Still, in many department stores, the departments handling teen-age wearing apparel experienced a decline in sales volume. How can this be explained?
10. How can a publisher of college textbooks use information about population characteristics to anticipate probable demand ten or fifteen years into the future?
11. Make it a point to observe several afternoon television programs that appeal to grade school children. Note what products of general family use are advertised on such programs and explain why these products are advertised to a juvenile audience.
12. A merchandise manager of a large department store was astonished and provoked to discover that men's handkerchiefs were being sold largely in the women's handerkerchief department rather than in the men's furnishings department. How would you, as manager of the men's furnishings department, justify this situation? Should handkerchiefs be sold exclusively in the men's furnishings department? Explain.
13. William Smith commenced business as a children's apparel retailer in 1951. He established a large store in the downtown area of a midwestern city with a population composition comparable with that of the nation as a whole. The first year in business his initial orders included 125 size 4 and 125 size 5 spring dresses. Early sales were much heavier in size 4 than in size 5, and he promptly reordered additional size 4 merchandise from his manufacturing resources. Other retailers were apparently experiencing the same situation as manufacturers were swamped with orders for size 4 garments which had to be produced after orders were received. Delivery was

very slow and Smith lost a number of sales. Smith made a note on his merchandising plan to order a larger number of size 4 dresses for the following spring and a smaller number of size 5, which had not sold so well. The next spring this plan was carried out but he found that he was in an even worse situation. Sales in size 5 were very heavy, and many customers were dissatisfied with the poor selection of stock available after the first week or two of the spring season.

Explain why sales of one size of dresses could be larger than another size in any particular year. How could Smith have anticipated and avoided this difficulty?

4

CONSUMER MOTIVATION

The nature of the consumer market has been only partially indicated by the discussion in the preceding chapter, which dealt with population and its characteristics in relation to consumption. Also requiring explanation are the needs and wants of consumers, what prompts them to buy certain goods and at certain places, and the attitudes that cause them to react favorably or unfavorably toward different products, services, or kinds of marketing institutions. This is the task of the present chapter.

Consumer Needs and Wants. Much misunderstanding and some criticism of marketing in our economy stems from confusion regarding the needs as distinguished from the wants of people as ultimate consumers. For example, it is sometimes stated that the people of former generations had everything that they *needed.* Modern industrial and marketing activity is often criticized for making people "want things that they don't need." In the same sense, one may hear a person say that he "doesn't need" an automobile, or a typewriter, or a television set, meaning usually that he can get along without it. Similarly, a wage earner may be critical of advertising or personal selling effort which makes his wife want to buy new household appliances or new clothing when he believes that she "does not need them." When the word "need" is so used, it is generally meant to refer to something absolutely necessary or indispensable.

Another common meaning of *need,* and one often found in dictionaries, *is the lack of something requisite, desirable, or useful.* This is believed to be a more proper and more sensible interpretation of the term. When needs are so interpreted, there is certainly no lack of them anywhere in the world. To be sure, some needs imply more urgency than others. All people require food to sustain life, and clothing and shelter for protection from the elements of nature. But they need much more than this. They need all of the goods and facilities for meeting the normal circumstances of life

in the social group of which they are a part; they need protection against uncertainties and hazards which may threaten the pattern of life to which they have become accustomed or which they prefer; they need the means of improving their present pattern of living so that they may live with more dignity and greater enjoyment. Life is so complex, its opportunities so varied, and our resources so limited, that it is apparent that most people will always need more things than they will be able to possess.

If such is the meaning of needs, then what is meant by wants? *To want a product is to recognize that it will satisfy a need.* Consumers are very directly conscious of many of their wants, but it is also true that they are made aware of others as a result of marketing activity. Marketing arouses, stimulates, modifies, or creates wants by making consumers aware or more conscious of their needs and by calling attention to specific products, services, or marketing institutions as the means of satisfying these needs.

While marketing institutions are very much concerned with arousing or creating wants, it is erroneous to interpret this in the sense of making people want things which they do not need. Actually, properly conceived selling effort stems from the premise that *wants arise out of needs*. The conversion of needs into wants is, however, often not a simple process. This may involve convincing the consumer, first, that some general kind of product or service will satisfy his want and, subsequently, that some individual brand or style number of a given product is the best specific solution to his problem. In order to accomplish this end, marketing organizations are dependent upon knowledge of consumer motivation. They are interested not only in the forces that motivate the consumer-buyer, who is often the housewife, but also in motivating other consumers who influence buying indirectly by expressions of their wants within the consuming unit which is usually the family.

Buying Motives

Significance of Consumers' Buying Motives. Every seller should be cognizant of the motives that prompt ultimate consumers to buy certain goods or to have goods purchased for them. Articles vary in appeal to different individuals and to the same individual at different times. For example, a certain automobile may be bought by one person because of a careful study of its mechanical features, and by another person purely because of a desire to imitate a social or business leader who drives that particular car. A life insurance salesman may easily err by basing his appeal on a prospect's desire to protect his loved ones when that particular prospect might be more easily influenced by a consideration of life insurance as an investment.

Because advertising presents a standardized appeal to a large group of potential purchasers, the success of a campaign depends largely upon the

degree to which the motives of importance to a majority of the members in the market are recognized. Personal sales effort can be individualized. In this case, the motivation of particular consumers who may differ considerably from one another is the essential consideration.

Consumer motivation is a complex subject, because a number of different types of motives are usually involved in any specific buying decision. Some of these are likely to be of negligible influence while one or only a limited number may be really governing. A further complication is presented by the fact that the *purchaser* of consumer goods may be someone other than the actual consumer. Many items are purchased as gifts for someone else. Numerous housewives are the routine purchasers of items of clothing and furnishings for their husbands and children. In all such cases, the determination of what shall be bought may be the result of the feelings and preferences of either the purchaser or the user, or a compromise involving both.

The classification of consumers' buying motives is fraught with many difficulties. Every social situation is different from every other and thus requires separate analysis for precise conclusions. There is actually no such thing as a universal set of explanatory motives, because individual motives are closely related to one another, are overlapping in meaning, and can be reclassified under a number of different headings. Psychologists have, however, contributed much of great value to the marketing student's knowledge of consumer behavior. The classifications discussed below, while by no means the only ones possible, do afford a realistic general picture of *consumers' buying motives,* that is, the group of influences or motivating forces which determine *what* purchases will be made.

Primary and Selective Buying Motives. Even a superficial study of the subject will reveal two distinct types of buying motives, primary and selective. *Primary buying motives* are those which induce an individual to buy a certain kind or general class of article. A housewife may decide that she wants a new rug for her home. The decision may be reached because of any one or a combination of several of the buying motives discussed in this chapter which unite to induce her to believe that a new rug should be substituted for the one which has been in use. The decision to purchase the new rug is based upon primary buying motives. After this decision has been reached, it is necessary for the housewife to select from a number of types of rugs, any one of which might have rendered satisfactory service. The reasons which influence the decision to buy a particular rug from among several possibilities are known as *selective buying motives.*

Other illustrations may help to make this point clear. Assume that a housewife is considering the purchase of an electric washing machine. She may want the product because of a desire to lessen the time and labor in

washing clothes. This is a primary buying motive. Unless it is offset by some stronger influence, it will sooner or later result in the purchase of some washing machine. Other primary motives may strengthen the desire until a definite decision has been reached to make the purchase. A particular make or brand of machine may then be selected from among those on the market. Other motives will determine which one is finally purchased. The decision may be based on the quality of the motor, on the preference of a certain kind of agitator, or may result from the cumulative influence of the past advertising of a certain machine. The various motives which determine what *particular* article will be purchased after primary motives have created the basic desire for the article are known as selective motives. For instance, the consumer who eats citrus fruit because of its health-giving qualities is swayed by a primary motive of health; but his decision to purchase Florida oranges, rather than California oranges (or vice versa), is based on a selective motive. As technology made television, automatic clothes dryers, and other such products commercially available, primary motives had to be aroused before selective motives could be brought into play and before such products could be marketed in substantial quantities.

Emotional and Rational Buying Motives. Every decision to purchase is the result of a definite mental reaction or process. This reaction may be emotional or rational, or it may involve something of each of these two elements. When the decision is reached as a result of an emotional rather than a rational mental state, the motive is characterized as emotional. This emotional reaction involves little or no consideration of definite arguments for and against a given course of action, and the inspiration is frequently to be found in the fundamental instincts of man. A rational reaction, on the other hand, is characterized by a more or less formal and deliberate consideration of the points for and against the proposed purchase. When such a mental process occurs the motive is deemed rational. Many decisions for and against a purchase are, of course, the result of a combination of the emotional and the rational.

Classification of Emotional Buying Motives. The following classification of emotional motives has been adopted, not because it is the only one possible, but because it seems to have the most significance for the student who is endeavoring to analyze the various reasons for consumers' purchases. No attempt has been made to classify motives in their order of importance, for obviously they vary in weight as between different individuals and on different occasions in the life of the same individual.

Prestige. Prestige, which also reflects pride and ambition, is one of the strongest emotional motives. The desire for prestige may be personal or it may relate to one's family, business or profession, or the success of an

organization to which one belongs. A clothing salesman may appeal to this motive when he stresses that the purchase of expensive clothes will set one apart from others who wear cheaper garments. Many goods are sold because they are expected to aid in the attainment of one's ambition in life. Illustrative are correspondence schools which may assist in advancing to an occupation with higher social status, or fine tools sold to a craftsman because they will result in the prestige associated with fine workmanship. Because the desire for prestige is so firmly grounded in human nature, selling appeals directed to this motive are often very effective.

Emulation. Man is essentially imitative. Appeals based on the fact that others are buying certain merchandise or that they are acting similarly in other respects are usually effective. Fashion and style appeals are made on the assumption that buyers are desirous of "being in style." Little consideration is given to rational buying motives so long as the commodity bought is the mode and is approved by the style leaders of the community. In the buying of other commodities this motive is a drive to "keep up with the Joneses." Testimonial advertisements, in which famous personalities from the field of entertainment or sports recommend the use of a product, often are an appeal to emulation.

Individuality. On the other hand, many individuals can be influenced by appeals to do or wear something new or different. Clothing can be sold to such individuals if they are assured that it will give them style prestige. Many persons like to drive the first car of a certain model to reach town or to be known as "first-nighters" in attending theaters and other places of amusement.

Conformity. Opposite in effect is the desire for conforming to social or family patterns of behavior. Many persons are not easily stimulated by appeals for individuality, for they are reluctant to do anything which differs from their habit pattern. They wait until a new style is firmly established before adopting it and then only in conservative form. The man who always wears the same shade of blue suit, the same kind of shirt collar, and the same type of necktie is illustrative. Also in this category would be the high school girl who wears saddle shoes because all the other girls wear them, or the suburban resident who has an outdoor charcoal broiler because all of his neighbors have one.

Comfort. The desire to be comfortable assumes at least two forms, the desire for personal comfort and the desire for the comfort of one's family. Personal comfort depends on a number of factors, one of which is health. Vitamins have been sold on an appeal based on the desire to avoid the discomforts of poor health. The sale of prepared children's foods, especially for babies, has been stimulated by appealing to the desirability of insuring

the health of children through proper precautions in the selection of their food. Appeals to the comfort motive are used by manufacturers of heating and air-conditioning systems and of electric fans. Labor-saving devices of all kinds are sold through appeals to buying motives based on the common desire to avoid or minimize physical work.

Pleasure. The widespread desire for pleasure or recreation is often based on a wish for change from the drab monotony of daily duties. An emotional appeal to this motive is used for different kinds of entertainment outside the home, including spectator amusements and participant sports such as hunting, fishing, or golfing. It is also encountered in connection with articles used in the home, including musical instruments, radios and television, games, toys, books, and magazines.

Creativeness. Many people have a basic desire for the emotional security which comes from diversionary creative activity and which goes beyond the mere requirements of pleasurable pursuits. Lumber dealers have discovered that they can do substantial business by assembling necessary tools and accessories for various kinds of home "do-it-yourself" projects. Often an individual will spend more money for the parts and material to make a coffee table than would be required to purchase a mass-produced item of better quality, merely to satisfy a creative urge. The same motive explains the relatively recent popularization of art and the sale of kits of equipment to those who wish to learn to draw or paint.

Classification of Rational Buying Motives. As has been indicated above, the most significant difference between emotional and rational buying motives is that appeals designed to arouse rational buying motives involve the deliberate use of judgment or formal reasoning rather than the emotions. Advertising which stresses appeals to rational motives is called "Reason Why" copy. The following classification is suggestive of the most important types of rational motives.

Dependability. One of the strongest rational motives is dependability. The buyer of a fountain pen, while not immune to emotional appeals, wishes to be assured that the pen will be ready for use under all circumstances, that it will hold a generous supply of ink, and will not leak. Dependability may be the most important factor in determining whether a certain manufacturer will purchase a commercial airplane for regular trips to a branch factory. Unless he is reasonably sure that airplane communication will be safe and reliable, he will use an automobile or the railroads, even though the sacrifice of time is involved.

Economy. With few exceptions, purchasers are influenced by considerations of economy in determining what articles to buy. Exceptions are found in the case of those with spendthrift tendencies and of the few persons

whose income is so great as to make economy relatively unimportant. Economy is usually viewed from two angles, the economy of the original purchase and the long-run service test of economy. Buyers differ in the extent to which they realize this fact, and hence there is always a certain proportion of the buyers of a given commodity that can be influenced by appeals based on the supposed economy of relatively cheap merchandise. Most bargain or price appeal retail advertising copy is based on the recognition of this fact. Other advertisers and many salesmen are able to sell quality merchandise by showing the long-run economy of buying relatively expensive articles.

Money Gain. Money gain is a rational motive appealing to practically all buyers. It may be used as a direct or an indirect appeal for many classes of merchandise. A suit of clothes, for example, may be sold on a purely bargain appeal basis or by using the "Dress Well and Succeed" slogan. Any appeal based on an alleged opportunity to increase one's earnings or the earnings of one's business rests ultimately on the recognition of the universality of money gain as a buying motive. The fact that money is useful only as it is exchanged for commodities does not weaken the appeal.

Convenience. Appeals to convenience are rational in nature if based on the convenient use of the article itself or its container. This is illustrated by the device commonly attached to packages of table salt to make it easy to pour the salt into containers, or the inclusion of certain other matter in the salt to facilitate its use in damp weather. Such appeals are similar to the emotional appeal to comfort but are more easily justified because definite reasons can usually be given.

Conscious and Dormant Motives. Any of the specific emotional or rational motives described above may be either conscious or dormant. Conscious motives are those which are clearly experienced by the consumer without being aroused through the instruments of marketing strategy. For example, a young executive who is anxious for a promotion may receive an invitation to a social gathering at which there are likely to be several important officials from his company. He may immediately decide to purchase a new suit of clothes of a particular quality and style because he believes that this will add to his prestige, aid him in attaining his ambition in life, and because it is somewhat in conformity with the tastes and expectations of the group with which he desires to become more closely associated.

On the other hand, there are many motives which are dormant in the sense that they are unrecognized by the consumer until brought to his attention. As a result of marketing strategy, definite appeals are directed at masses of people, at specific groups, or to individuals, which have the effect of creating wants by making people aware of certain needs which previously

were not consciously felt. Illustrative of this is the case of a man who has been so engrossed in business and family cares as to make it impossible for him to give much time in life to any form of recreation. Properly worded appeals emphasizing the attraction of football, the theater, golf, or the social contact of a good club may bring about the realization that he will be able to accomplish more work if he devotes a portion of his time to some wholesome pleasurable pursuit. When this motive has been aroused, different recreational appeals will reach him with some force.

Many articles depend for their demand on the possibility of arousing dormant or unconscious motives which can be appealed to by new articles or new uses for an old article. A household varnish which can be easily applied by an unskilled painter appeals to those who wish to enhance the appearance of the home and furniture. The want, while present, had not been aroused until a specific article was presented for use. Electric floor polishers, when first placed on the market, met a ready demand since they appealed to the desire to save labor, a desire which is almost universal, and also to take pride in the appearance of one's home.

Patronage Motives

Why consumers buy certain kinds of merchandise and the nature of the appeals used to arouse the appropriate buying motives have been indicated above. It has not yet been shown, however, why a consumer goes to a particular store to buy an article after the desire to purchase it has been aroused. *Motives which determine just where or from whom purchases will be made are known as patronage motives.* Appeals to these do not tend so much to arouse a desire for an article as to persuade the customer to buy from one of several possible sources.

Reputation of the Seller. The reputation of the seller is a very common patronage motive. Certain business firms have the reputation in a community of being absolutely reliable in all relations with customers. Other stores have been known to indulge in unethical practices. Either type of reputation is certain to affect the decision of a prospective purchaser. Other things being equal, he normally prefers to patronize the firm which has the better reputation. Some firms are known to have courteous salespeople and executives. Others are supposed to offer exceptionally fine values year after year. In the women's ready-to-wear field, certain stores commonly have the most exclusive merchandise or the latest fashions. All of these factors, if known, aid in determining the selection of firms from which to buy.

Services Rendered. Department stores have sometimes seemed to contend with each other as to which one could render the most service to its

customers. Restrooms, organ recitals, attractive tearooms, etc., though they may not pay directly, are factors in building up patronage for stores.

Jewelry or appliance stores which are known for careful and honest repair departments gain thereby, since many purchases of new articles are predicated on their superior repair service. Prospective customers often choose the automobile agency which renders the most complete and reliable repair service after the car is in use, even though another agency might be more conveniently located or even in spite of friendship with a proprietor or a salesman of an agency which is known to give poor service. Promptness and economy in installing certain types of merchandise may also lead to the selection of certain stores by buyers.

Breadth of Assortments. Many articles can be purchased to best advantage only when a sufficient assortment of styles, colors, sizes, and prices is available. This is true of ready-to-wear apparel, novelty and gift merchandise, textiles sold from the bolt, and, in general, of all articles which appeal to varying tastes or for which there exist style preferences. In such cases the customer wishes to consider a number of possibilities before deciding just which article to buy. Stores handling such merchandise but doing a relatively small volume of business are often handicapped in attracting trade. Customers prefer to patronize stores which are known to offer a wide range of articles in a given class. This type of appeal has been in part responsible for the growth of supermarkets in the grocery business.

Price. Price is an important patronage motive, and it is closely allied to the rational buying motive, economy. Many consumers carefully consider the question of price in determining what articles to buy and where to buy them. Certain stores definitely appeal to this motive by advertising that they operate on a cut price or "discount" basis and by stressing a comparatively low level of prices. Other stores emphasize quality merchandise at a somewhat higher price level and seek the patronage of that portion of the community which is less price conscious. Retail institutions take on a pretty definite character in the minds of buyers, and many decisions to patronize a certain store are reached because of a desire for economy. Other buying and patronage motives tend to weaken the price motive, but it is, nevertheless, a widespread consideration in patronage.

Belief in a Certain Channel of Distribution. Many customers have convictions which influence their decision as to which of several types of stores will secure the bulk of their patronage. For example, many farmers and others believe that as a rule large mail order houses sell merchandise at a lower price level than can be obtained in local stores. Hence they buy substantial quantities of merchandise from mail order houses. Others believe just as firmly that the local merchant deserves their support and that, on the whole, when the difference in service and convenience is considered, goods

can be purchased just as cheaply from him as from a mail order house. Some people patronize house-to-house canvassers as a matter of policy while others commonly refuse to buy from them. Chain stores are believed by many to offer the most economical method of securing the lines of goods they handle, while many others believe in the desirability of patronizing independent stores.

Convenience of Location. Most consumers prefer to buy at the most convenient places, unless this is offset by other patronage motives. This is especially true of the purchase of convenience articles and is less true when applied to specialties and to style goods. If a nearby store can supply the same merchandise which is handled by a more distant store at approximately the same price, it secures a large part of the business of the community. Consumers will not drive to a distant town or city or order goods by mail unless there is a specific reason for such action. One reason for the popularity of mail order houses is the ease and convenience of ordering from a catalog when stores are not conveniently located. Many purchases are made because of a momentary impulse created by seeing articles on display, or because the consumer has just remembered that he needs a certain commodity. He tends to go into the store which has the display or into the first store which handles the merchandise, the need of which he has just realized or remembered.

Motivation Research

The preceding discussion throws light, in a general way, on the basic motives or considerations that prompt ultimate consumers to buy the goods they purchase and at the places of their choice. It does not reveal, however, in a specific manner and with any degree of accuracy just what part a given motive plays in the consumer's decision to act or in the attitude he assumes. Yet this more specific knowledge is essential to the selection of selling appeals that are in harmony with consumer motivation and which make possible the efficient performance of the marketing task. This desire to harmonize selling appeals and effort with the buying interest of consumers has led many manufacturers and marketing organizations to spend millions of dollars annually in consumer research aimed at discovering true consumer-buyer motivation in some measurable way.

To discover why consumers act the way they do in buying goods and in patronizing certain sellers, different methods and types of techniques have been used for many years, ranging from mere observation and counting devices to elaborate questionnaire surveys. The latter have, in turn, ranged from simple types intended for extensive coverage to complex ones designed for depth interviews on an intensive basis. All of these have helped to unearth valuable "why" information concerning the actions and attitudes of ultimate

consumers and to that extent must be regarded as a form of motivation research.

More recently emphasis has been placed on projective and other psychological or even psychiatric methods and techniques of consumer research, for which the all-embracing designation of motivation research was inappropriately appropriated. In fact, in some respects this type of research is not as scientific as some of the older methods and techniques, because the conclusions about an identical universe are not usually reproducible when studied by different practitioners whose interpretations and evaluations may differ substantially.

Nature of Motivation Research. In its true sense, the task of motivation research is to find out just what makes people behave as they do, regardless of the technique or method used for the purpose. As a matter of fact, the term "motivation research" is equally applicable to all methods and techniques designed to discover reasons why people act or think the way they do, whether in the capacity of ultimate consumers, purchasing agents, store buyers, or in any other capacity. So far, however, the term has been applied principally to consumer motivation studies. In connection with marketing, it is largely concerned with consumer buying and patronage motives, as previously discussed in this chapter, and with consumer attitudes.

An attitude may be defined as a tendency to respond favorably or unfavorably toward a person, an institution, a thing, or an idea. An individual's attitude in any given situation is usually a result of a variety of past influences, including his assumptions or beliefs, his social frame of reference, and sensations or feelings that he has experienced. Since an attitude is an effect of what one has experienced, it is also something of a prophet of future action in the sense that a consumer's conscious or unconscious feelings or moods largely determine whether and how he will react to certain selling appeals. For this reason, a growing part of marketing research consists of attempts to discover the attitudes of people who make up the markets and, whenever possible, to measure the magnitude of such reactions. Manufacturers and marketing institutions are interested not only in the motivations of their *customers,* but also in the attitudes of those who have not used, or have discontinued to use, their products and services.

Although research in consumer motivation has been popularized to a high degree in recent years, it is not essentially a new concept. Some of the early books on marketing devoted considerable attention to consumer motivation, and elaborate classifications of buying motives were presented in the marketing literature of the early 1920's.[1] Contemporary developments

[1] One of the pioneering classifications of buying motives was that offered by M. T. Copeland in *Principles of Merchandising* (Chicago: A. W. Shaw Co., 1924), chaps. vi and vii.

have been associated chiefly with refinements in research methodology and in the increased appreciation, on the part of marketing executives, of the practical application of motivation knowledge to marketing problems. This may be better understood by giving brief attention to methods of motivation research and to actual illustrations of such research findings.

Motivation Research Methods. For purposes of the present discussion, methods used to obtain information about consumer attitudes or buying behavior may be classified into three groups, namely, observation of consumer action, consumer surveys, and psychological approaches.

Most early classifications of buying motives depended largely upon careful observation of consumers' reactions to different kinds of stimuli. If an advertisement stressed a selling appeal directed to a particular buying motive, and if this evoked considerable favorable response, then it was concluded that this particular motive was of considerable importance to consumers purchasing the product. There are many instances in which a change in selling appeals provoked such a significant response that the importance of certain motives could be inferred with reasonable certainty. While this is an old method, it continues to be highly relevant in situations where consumer reaction to certain stimuli is quite pronounced. This may be illustrated by reference to patronage motives under modern conditions. Following World War II, discount houses grew in importance in many metropolitan markets. When such stores are located outside the main stream of shopping traffic and hence are relatively inaccessible to many consumers, when they do not offer the usual range of customer services available in regular stores, and when the merchandise often has to be ordered from a catalog necessitating some delay between purchase and delivery, it does not take an elaborate survey or psychological analysis to determine that price concessions constitute the principal patronage motive.

Consumer surveys have often been utilized in situations where consumer motivations cannot be inferred with reasonable certainty from direct observation of consumer actions in the market. This approach usually involves the selection of a representative sample of the public, or of the presumed market for a particular product or service. Consumers are polled and are asked to state why they buy some particular product or patronize some particular marketing institution. Analysis of such questionnaire replies may reveal what motives or attitudes are of great importance to many consumers and which are of only incidental or no significance in the kind of situation being investigated. Such surveys have revealed that consumers prefer to shop in downtown stores rather than in outlying shopping centers because of the broader assortments of merchandise available, the greater emphasis upon bargain or clearance sales, and the feasibility of combining shopping with other things that one may want to do. At the same time they have re-

vealed that many prefer to shop in outlying centers because of lower cost for transportation, better parking facilities, more convenient store hours, ease of taking children on shopping trips, and other reasons.[2] In connection with selective buying motives, such surveys may reveal that most consumers buy one brand of a product rather than another because of a price differential, a reusable package, or some premium that is offered in connection with the product. Such surveys are a particularly appropriate method for motivation research in kinds of situations where consumers know why they have reacted in a given manner and when they are willing to state their reasons or attitudes.

More elaborate psychological approaches have become increasingly popular because of a growing recognition that there are some kinds of situations in which consumer behavior is a result of complex personality variables rather than a simple reaction to easily identified stimuli. Often, the consumer has given little systematic thought to buying situations and may not actually be aware of all the considerations that entered into his purchasing decisions. Moreover, there are instances in which consumers know why they bought something or what their attitude is regarding a situation, but are reluctant or even unwilling to state their true motives or opinions when approached by researchers who ask straightforward questions. Such circumstances have led to a number of refinements in research techniques, treatment of which is beyond the scope of this text. In general, it may be said that they involve the use of probing procedures, depth interviewing, and other projective techniques that have been borrowed from the fields of personality studies and clinical psychology where they have been used for many years. Such procedures are now often utilized in the field of marketing, particularly with respect to consumer buying behavior.

Illustrations of Motivation Research Findings. Motivation research studies, whether of the general survey or psychological approach type, reveal that consumers often do not think in terms of general classifications of buying motives but rather in terms of quite specific features of a product or a service. From very concrete consumer reactions, it is necessary to form hypotheses or generalizations about the basic underlying motives. The nature of such findings and the character of their application to questions of marketing strategy may be illustrated by several examples.

1. A prune growers' association, while suffering a continuing decline in sales, decided to find out what consumers thought about prunes. In detailed interviews, it was learned that consumers thought prunes were dry and wrinkled—ugly things to behold; that they were believed to be without particular food value or were to be used only as a laxative. As a result of this

[2] Cf. C. T. Jonassen, *The Shopping Center Versus Downtown* (Columbus: The Ohio State University Bureau of Business Research, 1955).

research, marketing strategy was changed. Most prunes are now distributed in cans or glass jars. They appear on supermarket shelves as fat, juicy, "prune plums." They are associated with fruit and with the quality of freshness. Sales have improved, bringing more consumer satisfaction with increasing consumption and with benefits to the producing industry.[3]

2. An important book club had stressed as its major appeal the savings that members realized on the purchase of each book. It asked a leading consumer motivation research organization to develop new appeals which were better attuned to consumer wants and interests. As a result of the research it was found that many members ordered a few books, then felt so guilty about not reading them that they dropped out of the club. The research organization recommended new appeals that would stress the club as a means of building a lifetime library. This was a more mature concept of continuity and long-run benefit. It proved to be more closely attuned to consumer interests and was responsible for an increasing and a more active club membership.[4]

3. Some time ago, an advertising executive wanted to know why instant coffee products had come to be regarded as inferior substitutes for regular coffee even though the instant coffee had been originally introduced as an expensive concentrate. Only a little probing revealed that his own advertising agency had been instrumental in offering a brand of instant coffee where it constantly emphasized appeals of "savings," "deals," "bargains," and "economies."[5] This example serves to indicate that the appeals used in attempts to sell the product, if not properly chosen, may result in consumer attitudes unfavorable to the use of the product. Appeals stressing flavor or convenience in preparation may have increased the use of the product more than the appeal to economy.

4. A leading manufacturer of prepared food product mixes, anxious to improve his sales position, utilized motivation research and learned that many women were subconsciously unwilling simply to place something in the oven and turn on the heat. The product provoked an image of a lazy housewife, whereas many consumers wanted to feel that they had more of a share in creating the results. It was found that many women limit the use of prepared products to luncheons and less important meals. The company developed a new marketing approach that involved separate packaging of different ingredients. In the case of pies, for example, the crust would be in one package and the filling in another. This also offered more freedom of choice —combining different kinds of fillings with different kinds of crusts. While

[3] Example cited by Robert E. Waugh, "Motivational Research—A Scientific Tool," *Arizona Business and Economic Review*, March, 1955, p. 4.

[4] Example cited by E. A. Dichter, "What Are the Real Reasons Why People Buy Today?" *Sales Management*, February 15, 1955, p. 50.

[5] Example cited by Burleigh B. Gardner and Sidney J. Levy, "The Product and the Brand," *Harvard Business Review*, March–April, 1955, p. 39.

still offering prepared products which appealed to a desire for convenience, the new approach appealed more to individuality and the desire to create.[6]

5. A leading airline serving a large section of the country felt that its rate of growth was not commensurate with the potential of air travel. In its advertising, it had constantly stressed the *safety* of air travel and its own excellent safety record. Motivation research revealed that this appeal produced "feelings of posthumous guilt" among many professional travelers, meaning that if they took a plane instead of a train and were killed in a crash, their families would suffer and it would be their fault. Constant emphasis upon *safety* evoked responses or attitudes which were adverse to air travel. As a result of the research, selling appeals were shifted from safety to the amount of time saved. The new strategy stressed the point that the air traveler would have more time to spend with the family that occupies one's thoughts.[7]

The foregoing examples are merely illustrative but they do demonstrate that consumers have attitudes toward products and services which are directly influenced by the short-run policies and plans of marketing executives in a particular company and by the action of persons employed in individual business establishments. While consumer attitudes toward the general question of branded merchandise are well grounded and relatively stable, attitudes toward a particular brand of a prepared food product may change radically and within a very short period of time merely as a result of a barely perceptible change in flavoring, the adoption of a new shape or type of container, or the modification of some other product characteristic. Likes and dislikes about a particular make of car may be drastically altered with the introduction of a new model with different style and engineering characteristics. Consumer attitudes toward a specific retail store may be considerably different before and after thorough modernization programs have been carried out in competing stores in the same shopping district. Such attitudes may also undergo rapid change if a lax personnel policy results in discourtesy on the part of salespeople, if a stricter customer return and adjustment policy is adopted, if the store begins to feature a price rather than a quality appeal, or for numerous other reasons.

Because the number of individual products and marketing establishments is legion and their interrelationships are so complex, and because consumer attitudes may change quickly and drastically, very few generalizations can be made in this area. Numerous studies and surveys have been made by interested parties as well as by marketing students in attempts to discover why consumers prefer certain stores, brands, or services or why they dislike them. The reactions may vary with the income or social status of the people interrogated, with business or other conditions, with geographic re-

[6] Example cited by E. A. Dichter, *op. cit.*, p. 54.
[7] Example cited by Robert E. Waugh, *op. cit.*, p. 3.

gions of the country, and with other factors. Many illuminating facts have thus come to light; but for the most part, to be of value from the standpoint of marketing management, they must be acted upon promptly after they become known.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) needs
   b) wants
   c) primary buying motive
   d) selective buying motive
   e) emotional buying motive
   f) rational buying motive
   g) conscious buying motive
   h) patronage motive
   i) motivation research

2. Point out and classify each buying motive included in the following quotations from advertisements:

   a) Your best calling card—A Rexbilt Leather Case—Smart business men size up visitors fast! And nothing adds quite so much to your prestige as a Rexbilt Brief Case. Crafted with the most meticulous workmanship, Rexbilt cases cost no more. Why not choose the finest?

   b) It's a fine feeling to *Know* you're correctly dressed—it gives you self-confidence that actually makes you look smarter. Wearing shoes of the *right* style and color is vital to this smarter appearance. For example, you can be sure you're correct when you wear any of the above handsome Jarman dress shoes with a blue or grey suit.

   c) There isn't any question—your home will be a lovelier, quieter place with Bigelow's Corday. Its thick, resilient, ripple texture wool pile gives your floors a soft, luxurious effect. Corday can be cut and joined *without sewing*. Edges need no binding because it is a Bigelow Lockweave. What's more, Corday resists footprints and scuff marks beautifully! Yes, home means more with carpet on the floor—especially if it's a Bigelow. Buy yours the Bigelow way—and have it in your home while paying for it.

   d) A part of good living . . . your telephone by your side. With telephones in living room, bedroom, kitchen and playroom, it isn't a question of keeping up with the Joneses. You are the Joneses!

3. Name and classify the buying motive or motives to which each of the following statements appeals:

   a) "Breakfast of Champions"
   b) "Hasn't scratched yet"
   c) "Give your face that wonderful feeling"
   d) "Ask the man who owns one"
   e) "99.44% pure"
   f) "Insurance will protect you and your family"
   g) "Buy an electric fan for the summer"
   h) "This exciting pen restores your confidence in what $1 will buy"
   i) "For the one man in seven who shaves daily"

4. Name the basic patronage motive or motives to which each of the following statements appeals:
   a) "We deliver free within 100 miles"
   b) "Ten weeks of free credit"
   c) "Established 1851"
   d) "Open every night till nine"
   e) "100,000 pair shoe store"
   f) "New York's style leaders at moderate prices"
   g) "The friendly store with the glass door"
   h) "Plenty of parking space"

5. The typical "cash-and-carry" chain department store makes a delivery charge when a customer desires to have her order delivered, and apparently the customer does not object to the practice. If the regular department store levied such a charge, it would be deeply resented. How can you explain such attitudes on the part of the consumer?

6. Clip and hand in a full-page advertisement from a recent issue of the *Saturday Evening Post* or a similar magazine. Indicate the buying or patronage motives which the advertiser has used. Were the appeals wisely selected, or are there others which would have been more effective? Explain.

7. In selling each of the following items today, would you appeal to primary or selective buying motives? Would you use rational or emotional appeals? Which emotional or rational appeals would you stress?
   a) A trip to Europe
   b) Oranges for breakfast every morning
   c) A Ford
   d) A vacuum cleaner
   e) Wheaties
   f) A stoker
   g) Weather stripping

8. Have you always been influenced to the same extent by the same buying motives? Explain.

9. In what ways, if any, would the appeals used to sell an automobile to a garage mechanic and a dentist normally differ?

10. How does the problem of selecting sound selling appeals differ between advertising and personal selling? Explain.

11. How is motivation research related to the efficient utilization of economic resources? Explain.

5

INCOME IN RELATION TO CONSUMPTION

In the two preceding chapters, attention has been directed to certain attributes of consumers as reflected by analyses of population and its characteristics and by concepts of consumer needs, wants, motives, and attitudes. The mere existence of *people* with *wants,* however, does not create markets or make possible a high level of consumption. Also required is the *purchasing power* to translate wants into effective demand.

Consumers possess purchasing power at any given time when they have income, wealth, or credit. In the long run, such power is limited to the first two sources. Of primary importance is income, for it provides *the continuing* flow of purchasing power and the principal basis for the use of consumer credit. Income may be supplemented at any time by withdrawals from wealth. For the most part, however, wealth is merely the income that was not consumed but was saved or accumulated in the past by its possessors or by their predecessors and other transferors. Because it represents a limited fund at any particular time, wealth cannot support a high level of consumption over extended periods, except in the case of a very limited number of families with exceedingly large hereditary wealth.

Income may also be supplemented by the extension of consumer credit, especially the instalment type which is used chiefly by people who cannot or will not pay the full price of a purchase out of current income. When this is done, the consumer merely commits his future income for current consumption. Barring bankruptcy, income must eventually come to the rescue to redeem the credit. Hence, *in the long run,* it is the total of income payments to individuals that sets the limit to the total of goods and services consumed by people.

In this chapter, the relationship between income and consumption is analyzed in considerable detail. Attention is directed to the level of total

income and total consumption, to particular categories of consumer expenditures, and to variations in consumption by levels of family income. Wealth and credit, as supplementary forms of purchasing power, are examined in the following chapter, along with other factors affecting consumption.

Total Disposable Personal Income and Consumption

The character of demand and the pattern of consumption are largely predicated upon the total amount of income available for current expenditures. It is, therefore, of the highest importance in any real study of marketing that careful attention be given to the matter of total income and its distribution. Fortunately, there is now a vast fund of information available concerning income, which facilitates the study of its relationship to consumption, not only from the viewpoint of the student, but also from the standpoint of the marketing executive who must formulate plans and policies for business enterprise and the public official who is concerned with policy making on a national or more limited scale.

Production, Income, and Consumption. Essentially, *income arises out of production.* Production has been previously defined (Chapter 1) as the creation of utilities which, in turn, are the capacities of goods and services to satisfy human wants and desires. Our wants are satisfied, adequately or inadequately, by the goods and services produced in the economy. From a broad viewpoint, then, it is the total of the goods and services produced that constitutes the income of society. From the standpoint of an individual, income is the amount that our system of exchange determines as the value of his contribution in the productive process although income may be augmented in certain instances by transfer payments from the current or accumulated income of others as, for example, gifts, subsidies, social security benefits, and pension and relief payments. Various measures are now available that reveal the flow of income in the economy and its relationship to marketing and consumption. The student of marketing is in a better position to analyze the operation of our economic system if he understands the concepts underlying these measurements. Furthermore, they are of incalculable value to the marketing executive who wishes to analyze variation in the consumption of his product or products and to estimate future demand or to determine market potentials. They also form the basis for much of our public economic policy.

The relationship between various concepts of production and income is illustrated in Table 2, in which U. S. Department of Commerce data are

presented for the year 1955.[1] The general level of economic activity is reflected in a very comprehensive manner by published estimates of the *gross national product*. This concept provides for the measurement of the total monetary market value of all goods and services produced in the economy. In addition to goods and services provided by the business system, an allowance is also made for the value of services rendered by the government.

All of the gross national product is not available for consumption. Part of it must be used to replace assets which are used up or consumed in the productive process. Buildings and equipment used in agriculture, manufacturing, and trade depreciate and our stock of natural resources is depleted through the activity of the extractive industries. Adjustments to provide for depreciation, depletion, and accidental damage to fixed capital (as through fire or flood) are known as capital consumption allowances. These are deducted from gross national product to calculate *net national product*.

TABLE 2

RELATION OF VARIOUS CONCEPTS OF NATIONAL INCOME AND CONSUMPTION: UNITED STATES, 1955

	Amount (millions)	Per Cent of Gross National Product
Gross National Product	$390,860	100.0
Less: Capital consumption	31,338	8.0
Net National Product	359,522	92.0
Plus: Subsidies minus current surplus of government enterprises	297	
Less: Indirect business taxes and other minor adjustments	35,771	9.1
National Income	324,048	82.9
Less: Undistributed corporate profits, corporate profits taxes, contributions for social insurance and other minor deductions	40,766	10.4
Plus: Interest paid by the government, government and business transfer payments	22,780	5.8
Personal Income	306,062	78.3
Less: Personal taxes	35,489	9.1
Disposable Personal Income	270,573	69.2
Less: Personal savings	16,602	4.2
Personal Consumption Expenditures	253,971	65.0

Source: *Survey of Current Business*, U. S. Department of Commerce, July, 1956; adapted from Tables 3 and 4.

Some products are sold on the market at prices which exceed the incomes accruing to the manpower, capital, or land resources used in their production. The difference is due mainly to indirect taxes (sales, excise, property)

[1] The presentation in Table 2 and the following discussion have been simplified somewhat in order to focus attention on the *important* differences between each of the income concepts.

paid by business to the various government units. Such taxes do not, by current treatment in national income studies, constitute value added by production, but reflect arbitrary decisions of government as to the place or stage from which it wishes to procure revenue. Indirect taxes are subtracted from net national product to derive the *net national income* which measures the total net value of services performed by the various groups participating in productive activities. It therefore constitutes the basis of the claims of the factors of production to income.

Individuals do not receive all of the net national income. Corporation income taxes are paid to the government out of the income to which stockholders have a claim. Employers' contributions to social security funds are paid out of the income to which labor has a claim. Many corporations do not pay out all of the available income after taxes, but retain part of the profits for reserves or for business expansion. This explains the reasons for these deductions shown in Table 2. There are also certain additions to be made because individuals receive transfer payments which do not result from their current role in the productive process. Illustrative are social security benefits, veterans' pensions, relief payments, and unemployment compensation. When the national income is adjusted to provide for these respective deductions and additions, the result is known as *personal income*.

Individuals cannot normally spend the total of their personal income, because they must pay personal income and other taxes to government units. When such taxes are deducted from personal income, the resulting figure is *disposable personal income*. This concept, which measures the amount available for spending and saving, is of greatest value in explaining variations in consumption, and is deemed of utmost significance in analyzing both variations in total consumption over periods of time and the nature of the demand for various categories of consumption at any particular time.

Disposable Income and Total Consumption. Because income, when viewed from a social standpoint, is a term comparable in meaning with production in terms of value added, and because production is for the purpose of consumption, it is logical to deduce that there should be a close relationship between income and consumption. This is borne out by the data for gross national product, personal income, disposable personal income, savings, and consumption expenditures as shown in Table 3. If the year-to-year changes in each of these series are carefully studied, it is observed that each one changes, almost invariably, in the same direction as all of the others. Increases in the sum total of economic activity as measured by the gross national product are accompanied by increases in personal income, disposable personal income, savings, and personal consumption. The converse is also true. However, *the more comprehensive concepts do not bear as close a relationship to consumption expenditures as does the disposable income of individuals.*

In Table 3 the total amount of personal consumption expenditures has been expressed as a per cent of disposable personal income for each year.

TABLE 3

GROSS NATIONAL PRODUCT, PERSONAL INCOME, DISPOSABLE PERSONAL INCOME, SAVINGS, AND PERSONAL CONSUMPTION EXPENDITURES: UNITED STATES, 1929–1955
(Amounts in billions of dollars)

	Gross National Product	Personal Income	Disposable Personal Income	Saving (Dissaving)	Personal Consumption Expenditures	
	Amount				Amount	Per Cent of Disposable Income
1929	$104.4	$ 85.8	$ 83.1	$ 4.2	$ 79.0	95.1%
1930	91.1	76.9	74.4	3.4	71.0	95.4
1931	76.3	65.7	63.8	2.5	61.3	96.1
1932	58.5	50.1	48.7	(0.6)	49.3	101.2
1933	56.0	47.2	45.7	(0.6)	46.4	101.5
1934	65.0	53.6	52.0	0.1	51.9	99.8
1935	72.5	60.2	58.3	2.0	56.3	96.6
1936	82.7	68.5	66.2	3.6	62.6	94.6
1937	90.8	73.9	71.0	3.7	67.3	94.8
1938	85.2	68.6	65.7	1.1	64.6	98.3
1939	91.1	72.9	70.4	2.9	67.6	96.0
1940	100.6	78.7	76.1	4.2	71.9	94.5
1941	125.8	96.3	93.0	11.1	81.9	88.0
1942*	159.1	123.5	117.5	27.8	89.7	76.3
1943	192.5	151.4	133.5	33.0	100.5	75.3
1944	211.4	165.7	146.8	36.9	109.8	74.8
1945	213.6	171.2	150.4	28.7	121.7	80.9
1946	209.2	178.0	159.2	12.6	146.6	92.1
1947	232.2	190.5	169.0	4.0	165.0	97.6
1948	257.3	208.7	187.6	10.0	177.6	94.7
1949	257.3	206.8	188.2	7.6	180.6	96.0
1950	285.1	227.1	206.1	12.1	194.0	94.0
1951	328.2	255.3	226.1	17.7	208.3	92.1
1952	345.4	271.8	237.4	19.0	218.3	92.0
1953	363.2	286.0	250.2	19.7	230.5	92.1
1954	360.7	287.3	254.4	17.9	236.5	93.0
1955	390.9	306.1	270.6	16.6	254.0	93.9

* War years.
Source: *Survey of Current Business*, U. S. Department of Commerce, July 1956, Tables 2 and 3, pp. 10–13.

These percentages or ratios measure what has come to be known as the *average propensity to consume.* They show that, in the aggregate, consumers tend to spend practically all of their disposable income on current consumption, saving only a small portion of it. Normally, the proportion expended for consumption tends to be about 95 per cent, although some variation may be observed from this general tendency. In the depression years 1932–33 consumption expenditures actually exceeded the amount of disposable personal income. This period of economic stress was marked by the withdrawal of savings which were used for current consumption and by considerable indebtedness incurred for the same purpose; thus, instead of personal *savings* there were personal *dissavings.* After these worst of the depression years, current consumption returned to a level of approximately 95 per cent

of disposable income and this relationship was maintained, with only minor variations, until the years of World War II. During those years the spread between personal income and disposable personal income increased with larger rates of personal income tax and a higher level of income payments which brought many individuals into higher tax brackets. Durable goods were not available in quantities, as numerous manufacturing concerns devoted their efforts to war production. The consumption of many types of nondurable goods was curtailed through rationing and other economic controls. Appeals to patriotism encouraged savings through the purchase of war bonds. All these factors contributed to a declining level of personal consumption relative to disposable income and effectively bridled people's general propensity to consume. During World War II the proportion of disposable income expended upon current consumption was generally between 75 and 80 per cent. After the war, the removal of artificial restrictions on consumption and the increasing supply of consumer goods of all kinds were accompanied by a return to a more normal relationship between disposable personal income and personal consumption expenditures, especially in the years 1948–50. The period 1951–55 was characterized by consistently increasing levels of disposable personal income, and expenditures lagged behind their normal relationship, although a tendency was manifest in 1954 and 1955 in the direction of a more normal pattern.

The year-to-year changes in the amount of disposable personal income and the proportion of it spent upon current consumption reveal an important principle, which may be stated as follows: *Increases in the total amount of disposable personal income tend to be associated with decreases in the proportion used for personal consumption expenditures, and decreases in the amount of disposable personal income are usually accompanied by increases in the proportion expended for personal consumption.* This is another way of saying that during years of prosperity personal consumption rises less rapidly than disposable personal income, and in years of depressed business falls less rapidly.

A conclusion that may be drawn from the foregoing analysis is that consumers regard their standard of living, which consists of the satisfactions they consider essential to their well-being, as even more important than their current income, hence consumption is more stable than disposable income. The scale or plane of living at any one time consists of the goods and services actually consumed. In periods of adversity consumers attempt to maintain their scale of living as closely as possible to their desired standards. This will be done at the expense of curtailing savings or, if necessary, by the consumption of wealth and the incurring of debt. On the contrary, during prosperous periods income tends to rise somewhat faster than increases in living standards. At such times the scale of living can be maintained at the desired standards by expending a smaller proportion of total disposable income.

Disposable Personal Income and Retail Store Sales. A substantial proportion of total disposable personal income spent for personal consumption is represented by services generally outside the scope of marketing, such as rent and rental value of owner-occupied houses. The relationship between disposable income and total consumption of *tangible commodities* is more evident when comparison is made with retail store sales. It must be remembered, of course, that retail sales figures contain some purchases by customers for business purposes, such as automobiles and trucks, building materials, and farm implements, which *are not* included in personal consumption expenditures. Excluded from retail store sales, however, are consumer expenditures for house rentals, purchased transportation and public utility services, and other types of services such as medical care, amusements, education, and recreation which *are* included in personal consumption expenditures. Consequently, retail store sales must not be confused with personal consumption expenditures.

In the aggregate, total retail store sales have generally changed in the same direction as, and in amounts closely correlated with, changes in disposable income. This relationship is revealed by the data plotted in Figure 3. Prior to World War II, retail sales generally approximated 60 per cent of disposable personal income. The relationship was so constant that retail store sales could be predicted with only a small degree of error, given the amount of disposable personal income. During the war years, when consumption was curtailed for reasons already explained, the same relationship did not obtain. Retail store sales dropped considerably below the 60 per cent relationship prevailing for the preceding period. After the war, retail store sales established a relatively constant relationship of about 70 per cent of disposable income. As shown in Figure 3, sales of nondurable goods stores have manifested a much more stable relationship to income than sales of durable goods stores, which are much more sensitive to changes in business conditions and income levels.

Disposable Personal Income and Broad Categories of Consumption. The character of the usual disposition of consumers' disposable income is revealed by the proportions spent for twelve major categories of consumption as shown in Table 4. The years for which data are given are illustrative of wartime and peacetime conditions and of varying degrees of prosperity, depression, and recovery. In spite of momentous fluctuations in the level of economic activity, a rather consistent pattern of expenditures by major categories tends to persist.

Several deviations from the normal pattern of disposition consistency are of unusual interest. First, in the war period rent controls, gasoline rationing, and the scarcity of automobiles and other consumer durable goods were responsible for unusually low expenditures for housing, household operation, and transportation. Second, contrary to the expectations of many, food

expenditures rose considerably following World War II, accounting for nearly 34 per cent of disposable income in 1949 and over 32 per cent in 1955. This is explained partly by a rise in food prices relative to nonfood prices in the early postwar period; by dietary changes involving less con-

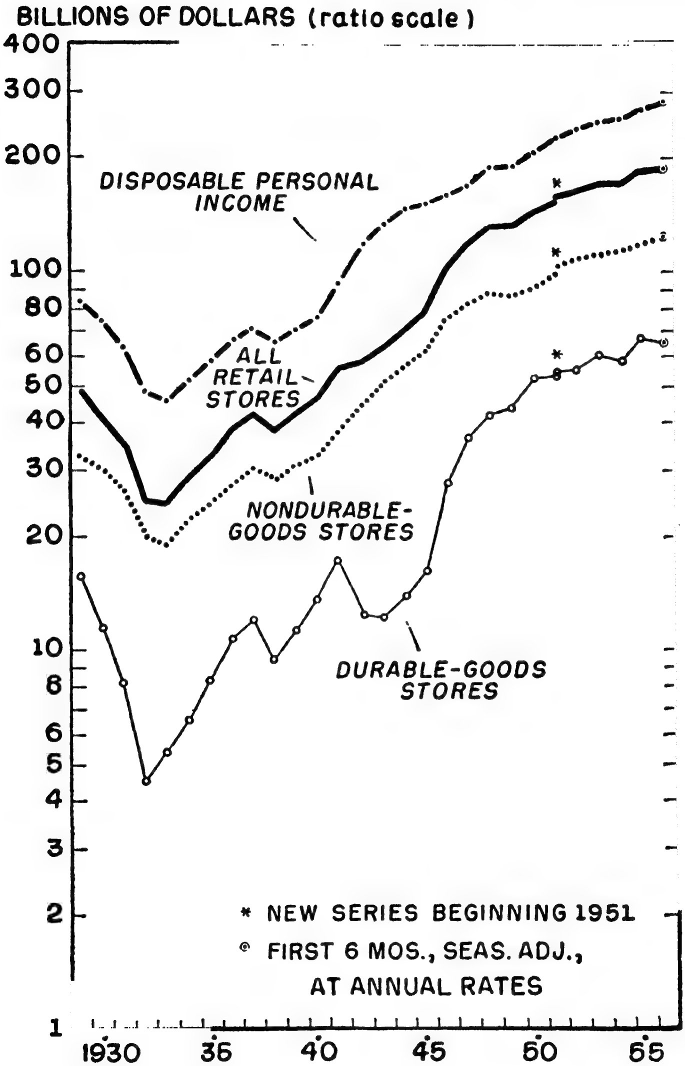

FIG. 3. Retail store sales in relation to disposable personal income, United States, 1929–1956.

Source: Clement Winston and Marie P. Hertzberg, "Regional Trends in Retail Trade," *Survey of Current Business*, September 1956, p. 12.

TABLE 4

DISPOSITION OF DISPOSABLE PERSONAL INCOME ACCORDING TO SAVINGS AND MAJOR CATEGORIES OF CONSUMPTION EXPENDITURES: UNITED STATES—FIVE-YEAR INTERVALS, 1929–1954, AND 1955

(Per cent of disposable personal income)*

Category†	1929	1934	1939	1944 (war year)	1949	1954	1955
Disposable personal income	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Less: Savings (plus dissavings)	4.5	(0.5)	3.8	24.1	3.3	7.2	6.1
Personal consumptions expenditures:	95.5	100.5	96.2	75.9	96.7	92.8	93.9
Food and tobacco	26.0	30.3	30.1	28.2	33.8	30.8	32.1
Clothing, accessories, and jewelry	13.4	12.5	11.8	12.3	12.3	9.6	10.1
Personal care	1.4	1.5	1.4	1.3	1.2	1.1	1.3
Housing	13.8	14.6	12.7	8.0	9.7	11.7	12.0
Household operation	12.7	13.8	13.6	9.2	12.6	12.1	13.3
Medical care and death expenses	4.4	5.1	4.8	3.8	4.8	4.6	4.9
Personal business	6.3	6.0	5.3	3.0	4.0	4.5	5.0
Transportation (including automobile)	9.1	8.7	8.9	4.0	10.4	10.6	12.7
Recreation	5.2	4.7	4.9	3.8	5.5	4.8	5.1
Private education and research	0.8	0.9	0.9	0.6	0.9	1.0	1.1
Religious and welfare activities	1.4	1.7	1.3	1.1	0.9	1.3	1.3
Foreign travel and remittances—net	1.0	0.7	0.5	0.6	0.6	0.8	0.9

* For dollar amount of disposable income and personal consumption expenditures in each year, see Table 3.

† For illustrative detail of items in major categories, see footnotes to Table 5.

Source: Derived from data in the National Income Supplement, *Survey of Current Business,* 1951, Tables 3 and 30; *Survey of Current Business,* July 1956, Tables 3 and 30, pp. 12–13 and 21.

sumption of inexpensive grains and starchy foods and more of high protein meats and expensive vegetables; and the merchandising of food items which require large amounts of processing as, for example, frozen fruits and vegetables, precooked meats, and packaged food mixes for instant or quick preparation. Third, clothing expenditures have declined in relation to income since 1949. Among the explanations for this are informality in dress with less emphasis on expensive items such as fur coats and suits and more stress on casual attire and the promotion of various types of synthetic materials which are considerably less costly than the wool and silk items they have tended to replace. Fourth, unusually large automobile expenditures in 1955 were supported by an unprecedented level of buying income and by a substantial expansion of consumer instalment indebtedness.

Disposable Income and Sensitivity of Specific Types of Expenditures. Under normal conditions, even *great changes in general economic conditions and in the dollar amounts of disposable personal income do not usually result in substantial changes in the proportion of disposable income expended for broad categories of consumption.* While total *proportionate* expenditures by broad consumption categories tend to remain relatively stable, this is not true of all their components. Consequently, if analysis is confined to broad categories of expenditures and no attention is given to the more specific types of expenditures within each such category, much of the income-consumption relationship of great marketing significance is obscured

or completely lost. For example, while it is of considerable import that expenditures for household operation are a fairly stable proportion of total disposable income, the marketing executive in a particular company is interested in much more detailed data, such as the income-sensitivity of consumer expenditures for furniture, major appliances, floor coverings, fuel, or public utility services.

Such relationships are closely allied to an economic concept of demand elasticity, of which there are several forms. Historically, greatest emphasis has been devoted to *price elasticity of demand* which is concerned with changes in demand that are associated with price changes when other factors (including income and promotional efforts) are held constant. Demand for a product is said to be elastic in this sense if the increase or decrease in demand is greater than unity; i.e., higher in proportion than the decrease in price or lower in proportion than the increase in price. Thus, if the price is reduced by 2 per cent and the demand for the product, in consequence of the price change, is increased by 2 per cent or less, the demand is inelastic; but if the demand is increased by more than 2 per cent, it is elastic.

Income elasticity of demand is a concept which involves changes in demand that are related to changes in income, when prices, promotional efforts and other factors are held constant. The demand for a product is elastic if a change in income by, say, 4 per cent results in a changed demand for the product by more than 4 per cent. Many marketing scholars have also become interested in a concept of *promotional elasticity of demand.* In applying this concept one would attempt to measure the degree to which the demand for a product is sensitive to increases or decreases in the seller's promotional effort or expenditures, under conditions when the influences of price or income changes are held constant or are isolated.

It is almost impossible to measure precisely the elasticity of demand for a product in relation to price, to income, or to promotional effort. Serious practical problems are encountered when attempts are made to isolate the effects of a change in just one factor when, in a dynamic economy, all of them and still other factors affecting consumption are changing almost continuously. Income elasticity, which is the primary concern of the present discussion, has been approximated in research studies in which the sensitivity to income of specific types of expenditures is measured by a coefficient derived from correlating dollar expenditures with disposable personal income. *The coefficient of income sensitivity expresses the average per cent by which expenditures have varied, over a period of years, corresponding to a 1 per cent change in disposable income.*

The business community has manifested such strong interest that the U. S. Department of Commerce has undertaken two comprehensive studies dealing with the income sensitivity of numerous types of products or specific items.

One such study involved the period 1929–40 and another the post-World War II years of 1947–54.[2]

The findings of such studies are of a detailed character but may be illustrated with a few examples. In the 1947–54 study it was found that the coefficient of sensitivity for total consumption expenditures during the eight-year period was 0.85, which means that a 1 per cent increase or decrease in disposable income was accompanied, on the average, by a corresponding change of 0.85 per cent in aggregate consumption expenditures. Thus, items with coefficients below 0.85 have lower than average income sensitivity and items with greater coefficients have higher than average sensitivity. An example of much higher than average sensitivity is afforded by automobiles for which the coefficient was 1.7. This means that an increase (or decrease) in disposable personal income of 1 per cent was associated, on the average, with a 1.7 per cent increase (or decrease) in this category of expenditures. Under 1947–54 market conditions, therefore, a 5 per cent increase in income would be expected to result in an 8.5 per cent increase in automobile purchases (1.7×5). Women's and misses' apparel expenditures were quite stable in dollar amount over the 1947–54 period, in spite of an increasing income trend. This resulted in a very low coefficient of only 0.1 for this item. A 10 per cent increase in income would be expected to result in only a 1 per cent increase in this category of expenditures, which, during the period in question, was highly inelastic with reference to changes in income.

Coefficients for a wide range of items have been made available in these studies and have proved helpful to marketing executives in estimating demand. They have also led many consumer goods manufacturing companies and retailing organizations to study their own sales carefully in relation to current estimates of disposable personal income, as published regularly in the *Survey of Current Business.* When judged in proper perspective, along with other factors that also influence consumption, such income sensitivity relationships not only have proved valuable for purposes of future estimation, but also permit the more realistic appraisal of the effectiveness of marketing efforts in current periods for which income is already accurately known.

Family Expenditures by Income Levels

Just as the people as a whole cannot, in the long run, consume more than the total national income, so is it with the individual or family unit.

[2] See Clement Winston and Mabel A. Smith, "Income Sensitivity of Consumption Expenditures," *Survey of Current Business,* January, 1950, pp. 17 ff.; and Louis J. Paradiso and Clement Winston, "Consumer Expenditure-Income Patterns," *Survey of Current Business,* September, 1955, pp. 27 ff.

An individual may, by drawing on his accumulated savings or wealth or by means of credit, consume more for a limited period of time than he can purchase out of his current income. Such a procedure ultimately exhausts his principal and his debt-paying power. Furthermore, most consumers have no substantial accumulations of wealth or claims to it upon which to draw.

Generally speaking, therefore, the disposable income of the individual sets the limit of his consumption, just as the consumption of a people over a period of years finds its maximum limit in the national income. The income of the individual or of a family is, therefore, the prime factor in determining the standard or level of living for the family. Because living standards and expenditure patterns vary considerably with the amount of income available to a family, the distribution of income among the people is of great significance to those engaged in marketing.

Expenditure Patterns in Relation to Income. Some individual members of a given income group distribute their incomes as between food, clothing, housing, and other principal items in proportions somewhat different from other members of the same group. There is a strong tendency, however, for most people with comparable incomes to effect a somewhat similar distribution of their incomes in the major divisions of expenditures normally incurred in the course of living. Moreover, as an individual moves from one income level to another he tends in time to take on the standard of living of the new income group and to spend his income in somewhat the same proportion, so long as all factors including marital status, size of the family, racial characteristics, age and sex of the family members, are comparable to the average of the income level joined. These patterns of expenditure, as well as the total income available for disposal by consumers, are extremely significant to businessmen individually and to the economy as a whole, for they spell the amount of purchasing power that is available and who will likely share in the benefits of such purchasing power.

Early Studies of Subject. For that reason studies of how people use their income date back several centuries. One such study was made by Sir William Petty in 1672; he estimated purchases of the average workingman's family, for the purpose of determining the possibility of trade with Ireland. In 1795 an English clergyman published data on the living of families of 137 agricultural workers, the study having been prompted by a desire to learn why so many of the parishioners had to receive aid from the parish.

A series of case studies was begun after the middle of the nineteenth century based on observation of expenditures made by selected families. Since this type of study was begun by Frederic Le Play, a French mining

engineer who spent his vacations living with selected typical families in different parts of the world[3] and by Ducpétiaux,[4] all studies of this character have been known as case studies of the Le Play type.

Engel's Laws of Consumption. No studies of family living of a statistical nature had been made, however, until that published by Ernst Engel in 1857. As Director of the Statistical Bureau of Saxony, he was versed in statistical procedure and had the facilities for such an investigation. He thus discerned the relationship existing between the amount of available income and the proportionate expenditures for certain major classes of consumption goods, which was the basis for the formulation of what came to be known as "Engel's Laws of Consumption." Apparently Engel was primarily, though not altogether, concerned with family expenditures for food; for he believed that the proportion of outlay used for food, other things being equal, is the best measure of the material well-being of a people. Accordingly, he formulated what later became known as the basis of Engel's laws of consumption as follows:

> . . . je ärmer eine Familie ist, einen desto grösseren Antheil von der Gesammtausgabe muss zur Beschaffung der Nahrung aufgewendet werden . . .[5]

Translated, this means that "the poorer a family is, the larger the share of the total expenditures which must be used for food."

In his investigations, however, Engel had compiled data on other types of expenditures which were used by other students of consumption.[6] One of these was Carrol D. Wright, head of the Bureau of Statistics of Labor of Massachusetts, who in 1875 supervised a budget study of 397 workingmen's families in that state. The first complete statement of "Engel's laws" was

[3] *Les Ouvriers Européens* (Paris, 1855).

[4] *Budgets Économiques* (Brussels, 1855).

[5] Ernst Engel, "Die Productions- und Consumptionsverhältnisse des Königreichs Sachsen," *Zeitschrift des Statistischen Bureaus des Königlich Sächsischen Ministeriums des Innern*, No. 8 u. 9, Sonntag, den 22, November, 1857, p. 8. Acknowledgment is made to assistance on this point through a special study, from the original publications secured on loan from the Library of Congress, by Marvin Hoffman under the supervision of one of the authors.

[6] In a table, which appeared in Engel's first publication referred to above and was later reproduced by him in another study (*Rechnungsbuch der Hausfrau und Seine Bedeutung im Wirtschaftsleben der Nation* (Berlin: Leonhard Simion, 1882), p. 44, he presented data on the proportion of total outlay for each of three income groups for subsistence or food (Nahrung), clothing (Kleidung), lodging or rent (Wohnung), heat and light (Heizung und Beleuchtung), education, religion, etc. (Erziehung, Unterricht, Seelsorge), legal protection and insurance (Rechtschutz, öffentliche Sicherheit), care of health (Gesundheitspflege), and comfort, mental and bodily recreation (Bequemlichkeit, geistige und leibliche Erholung).

apparently that formulated by Wright in comparing the results of his own study with conclusions drawn by him from Engel's data, as follows:[7]

> *First.* That the greater the income, the smaller the relative percentage of outlay for subsistence
>
> *Second.* That the percentage of outlay for clothing is approximately the same, whatever the income
>
> *Third.* That the percentage of outlay for lodging, or rent, and for fuel and light, is invariably the same, whatever the income.
>
> *Fourth.* That as the income increases in amount, the percentage of outlay for "sundries" (items such as education, care of health, comfort, and recreation) becomes greater.

Even though the last three of the four propositions were never stated as laws by Engel in his first writing on the subject in 1857, they apparently had his tacit approval, because he was familiar with Wright's work and referred to it in later publications without protesting Wright's interpretations.[8] Furthermore, in these later writings he referred to them as "soziale Gesetze," or social (economic) laws.

Regardless of their actual authorship, the foregoing four propositions have been popularized in the United States as *Engel's Laws of Consumption* and have been used generally to explain variations in consumption expenditures by income levels until more comprehensive data became available in fairly recent years in this country. It has been assumed that Engel, Wright, and other early interpreters of these laws took for granted that other things like the price level and family size would remain the same and made no allowance for any change therein. It has been assumed, further, that the laws would apply to the changing income of a single individual just as they do in the case of a family. Again, while the question of personal savings was not considered in any of these studies, it has been generally assumed that as the income of a family increases, the proportion saved is larger.

It is interesting to note that Engel's formulation is in terms of a family becoming poorer and receiving less income, while that of Wright was in terms of a family's income increasing, probably indicative of the outlook for the laboring classes in those days in the two respective countries. It would seem that the laws can be stated either way, the reverse being true in the case of families with falling incomes than of families with rising incomes. Another point of significance is that both Engel and Wright formulated the laws in terms of proportions, not in absolute amounts spent for any class of goods

[7] Wright and Potter, *Sixth Annual Report of the Massachusetts Bureau of Statistics of Labor* (Boston, 1875), p. 438.

[8] Such references are contained in Engel's *Rechnungsbuch der Hausfrau und Seine Bedeutung in Wirtschaftsleben der Nation,* p. 40, and in his *Die Lebenskosten Belgischer Arbeiter Familien, Früher und Jetzt* (Dresden: C. Heinrich, 1895), p. 29.

and services. Furthermore, the proportions were shares of total expenditures or *outlay, not of income.* In later writings, however, references are made by Engel more or less interchangeably to shares or proportions of both total expenditures (Gesammtausgabe) and total income (die Einkünfte, Einnahmen, or Einkommen) spent for different categories of consumption. This may be explained by the fact that in those days consumer credit was little used in Saxony and in neighboring countries, and wealth in liquid form that could be used for purchasing power as a supplement to income was not generally in the hands of the common man. Consequently, income and expenditure for a family were no doubt coextensive, the former setting the limit for the latter.

Expenditure Patterns of Families in the United States. Because of the widespread attention devoted to Engel's so-called Laws of Consumption, it is of great interest to determine to what degree they have been borne out by experience in the United States in modern times. Hundreds of studies of consumer expenditures have been made in this country. Most of them have been of a fragmentary nature and covered only a small sample of families. One of the most comprehensive of all covered the twelve-month period ended June 30, 1936. This was a Works Progress Administration undertaking known as "The 1935–36 Study of Consumer Purchases."[9] Most of the conclusions from this study were verified by the results of another substantial investigation along similar lines undertaken by the Bureau of Labor Statistics and the University of Pennsylvania in 1950. This was based upon a planned statistical sample of 12,500 urban families which provided 1,500 items of information about family characteristics, income, and consumption expenditures. The results, published in 1956 in 18 large volumes, comprise a wealth of marketing information that permits analysis of expenditures in relation to income levels and, with cross-classifications, by a large number of other family traits.

A summary of some of the results of this elaborate study is presented in Table 5. In interpreting such information, it is significant to note that families in different income classes vary in regard to a number of characteristics other than income. As shown in Table 6, families in the lower income groups are smaller than those on the higher income levels. In addition, the lower income families are characterized by a smaller number of wage-earners, more elderly people, more limited education, a larger per cent of nonwhites, and a smaller per cent of home owners. These variations, as well as those in income level, have some relationship to variations in consumption expenditures.

[9] For data from this study, see National Resources Committee, *Consumer Expenditures in the United States* (Washington: Government Printing Office, 1939). Also, Harold H. Maynard and Theodore N. Beckman, *Principles of Marketing,* 5th ed. (New York: The Ronald Press Co., 1952), pp. 95–99.

From the data in Table 5 it may be observed that there is a marked difference in expenditure patterns by major categories of consumption when dollar amounts are expressed as a per cent of disposable income and when they are expressed as a per cent of total expenditures. The difference between the two percentage distributions is accounted for by the fact that families in the lower income groups consume more than their current disposable income by using up savings, going into debt, or supporting current consumption levels with gifts or other subsidies. On the other hand, families in the higher income levels have more than what is needed to support their living standards; hence, the surplus of income over consumption expenditures is saved or invested.

A number of significant generalizations may be formulated from the data in Table 5. With very minor exceptions, these are also supported by earlier studies in the United States, particularly that of 1935–36 to which reference was made earlier. Disregarding, in some instances, the extreme cases in the lowest income class, they may be stated as follows:

1. Families in the higher income groups spend larger amounts but *smaller proportions of their total expenditures as well as of their total incomes* on food. In general, families in the higher income groups spend about a one-third smaller proportion of *total expenditures,* and less than one-half as great a proportion of *total income,* for food as do those in the lower income level. While these data do not indicate what happens when a family *moves* from one income level to another but simply show what proportion of their income families in each income bracket spent for food, it may be presumed that, in time, as one enters a higher or lower income bracket he tends to act like those in the new income level. To that extent dynamics may be implied from the data which purport to portray a static condition. It would thus appear that American experience in modern times is not unlike that reflected in Engel's laws with regard to proportions expended for food.

While increases in income are associated with decreases in the *proportions* expended for food, the absolute amounts spent for food increase with added increments in income and are, in fact, about six times as great in the highest income group as in the lowest. This happens, in part, because (1) a larger number of calories is purchased per family unit, (2) a greater variety of food is consumed, and (3) a shift takes place from so-called energy foods like starches with low caloric cost to so-called protective foods like fruits and vegetables with high caloric cost.

2. Expenditures for clothing *do not* remain a constant percentage of total expenditures as claimed in the so-called Engel's laws. Families in the higher brackets spend a much larger proportion for clothing than do those in the lower groups. In terms of *income,* however, the proportion expended for clothing remains relatively stable throughout all income levels except

TABLE

EXPENDITURES FOR MAIN CATEGORIES
BY LEVEL OF FAMILY DISPOSABLE

		Average expenditure					
			By major categories				
					Expenditures related to occupancy		
Income Level	Average Money Income After Taxes[1]	Total Amount	Food[2]	Tobacco	Total	Housing[3]	Fuel, Light, Refrig-eration
							(amount)
Under $1,000	$ 614	$ 1,278	$ 442	$ 15	$ 453	$ 239	$ 96
$1,000–1,999	1,532	1,768	642	36	553	277	107
2,000–2,999	2,534	2,718	943	58	766	348	131
3,000–3,999	3,487	3,570	1,171	70	948	411	155
4,000–4,999	4,462	4,450	1,382	84	1,177	486	176
5,000–5,999	5,449	5,257	1,588	87	1,348	539	194
6,000–7,499	6,618	6,043	1,756	95	1,542	620	209
7,500–9,999	8,434	7,108	2,055	103	1,785	704	240
10,000 and over	15,914	10,773	2,641	111	3,226	1,152	302
							(per cent of
Under $1,000	100.0	208.1	72.0	2.4	73.8	38.9	15.6
$1,000–1,999	100.0	115.4	41.9	2.3	36.2	18.1	7.0
2,000–2,999	100.0	107.3	37.2	2.3	30.3	13.7	5.2
3,000–3,999	100.0	102.4	33.6	2.0	27.2	11.8	4.4
4,000–4,999	100.0	99.7	31.0	1.9	26.4	10.9	3.9
5,000–5,999	100.0	96.5	29.1	1.6	24.8	9.9	3.6
6,000–7,499	100.0	91.3	26.5	1.4	23.3	9.4	3.2
7,500–9,999	100.0	84.3	24.4	1.2	21.1	8.3	2.8
10,000 and over	100.0	67.8	16.6	0.7	20.2	7.2	1.9
							(per cent of
Under $1,000	48.0	100.0	34.6	1.2	35.4	18.7	7.5
$1,000–1,999	86.7	100.0	36.3	2.0	31.3	15.7	6.1
2,000–2,999	93.2	100.0	34.7	2.1	28.2	12.8	4.8
3,000–3,999	97.7	100.0	32.8	2.0	26.5	11.5	4.3
4,000–4,999	100.3	100.0	31.1	1.9	26.5	10.9	4.0
5,000–5,999	103.7	100.0	30.2	1.7	25.7	10.3	3.7
6,000–7,499	109.5	100.0	29.1	1.6	25.6	10.3	3.5
7,500–9,999	118.7	100.0	28.9	1.4	25.1	9.9	3.4
10,000 and over	147.7	100.0	24.5	1.0	29.9	10.7	2.8

[1] Total money income, after deduction of personal taxes and occupational expenses. Does not include inheritances or gifts from persons outside the family.

[2] Includes expenditures for consumption on premises where expenditures are made as well as at home.

[3] Includes rent or expenses of owning and maintaining an owned dwelling.

[4] Includes utility services, laundry, cleaning, maid service, household insurance, household service and supplies.

[5] Includes purchase and operation of automobiles and all forms of purchased transportation service for commuting or travel.

5

OF CONSUMPTION FOR URBAN FAMILIES
INCOME: UNITED STATES—1950

for current consumption

of consumption

and operation of households

Household Operation[4]	Furnishings and Equipment	Clothing and Clothing Services	Transportation[5]	Medical Care[6]	Personal Care[7]	Recreation Reading, and Education[8]	Miscellaneous
$ 63	$ 55	$ 80	$ 92	$ 91	$ 25	$ 43	$ 35
82	87	163	140	96	43	65	28
113	174	280	296	144	66	127	39
145	237	385	476	196	83	203	39
186	329	509	639	226	99	281	52
236	379	645	814	254	116	329	76
280	433	774	944	300	128	418	87
387	454	963	1,098	373	148	488	95
865	907	1,519	1,378	446	201	841	310
disposable income)							
10.3	9.0	13.0	15.0	14.8	4.1	7.0	5.7
5.4	5.7	10.6	9.1	6.3	2.8	4.2	1.8
4.5	6.9	11.0	11.7	5.7	2.6	5.0	1.5
4.2	6.8	11.0	13.7	5.6	2.4	5.8	1.1
4.2	7.4	11.4	14.3	5.1	2.2	6.3	1.2
4.3	7.0	11.8	14.9	4.7	2.1	6.0	1.4
4.2	6.5	11.7	14.3	4.5	1.9	6.3	1.3
4.6	5.4	11.4	13.0	4.4	1.8	5.8	1.1
5.4	5.7	9.6	8.7	2.8	1.3	5.3	1.9
total expenditures)							
4.9	4.3	6.3	7.2	7.1	2.0	3.4	2.7
4.6	4.9	9.2	7.9	5.4	2.4	3.7	1.6
4.2	6.4	10.3	10.9	5.3	2.4	4.7	1.4
4.1	6.6	10.8	13.3	5.5	2.3	5.7	1.1
4.2	7.4	11.4	14.4	5.1	2.2	6.3	1.1
4.5	7.2	12.3	15.5	4.8	2.2	6.3	1.4
4.6	7.2	12.8	15.6	5.0	2.1	6.9	1.4
5.4	6.4	13.5	15.4	5.2	2.1	6.9	1.3
8.0	8.4	14.1	12.8	4.1	1.9	7.8	2.9

[6] Includes direct medical payments and all forms of related insurance payments.
[7] Includes barber, beauty shop services; toilet articles and preparations.
[8] Includes purchases of radios, television; admissions to theatres and spectator events; toys and hobby items; subscriptions to newspapers, magazines; books; and all family educational expense.
Source: *Study of Consumer Expenditures, Incomes and Savings* (Philadelphia: University of Pennsylvania, 1956), Volume XVIII.

TABLE 6

SELECTED CHARACTERISTICS OF URBAN FAMILIES BY LEVEL OF FAMILY DISPOSABLE INCOME: UNITED STATES—1950

	Characteristics					
	Average				Per Cent	
Income Level	Family Size	Full-time Earners	Age of Head	Education of Head[1]	Non-white	Home Owners
Under $1,000	1.5	0.1	65	8	16	42
$1,000–1,999	2.1	0.4	53	9	21	36
2,000–2,999	2.7	0.7	45	10	15	35
3,000–3,999	3.2	0.9	43	10	7	46
4,000–4,999	3.4	1.1	42	11	6	54
5,000–5,999	3.6	1.3	44	11	3	63
6,000–7,499	3.7	1.4	46	11	2	67
7,500–9,999	4.0	1.5	48	12	2	72
10,000 and over	3.7	1.2	48	13	1	82

[1] Years of formal education completed.
Source: *Study of Consumer Expenditures, Incomes and Savings* (Philadelphia: University of Pennsylvania, 1956), Volume XVIII.

those at the extremes. The absolute amounts spent for clothing are very much greater than the amounts spent for such purpose by persons in the lower income levels. Not only are more varieties of clothing purchased for special purposes, like sportswear, evening wear, etc., but the garments and accessories are of better quality and higher priced for those in the higher income classes.

3. Expenditures related to the *occupancy and operation of households,* when taken in the aggregate, are relatively constant in terms of total expenditures, which is in line with Engel's law on this point. In relation to total *income,* however, the percentage for this broad category declines consistently as each higher level of income is reached. Interesting variations may be observed for the subgroups within this category. In comparison with middle-income families, those in the highest income group spend about the same per cent of their total outlay for housing; a much smaller per cent for fuel, light, and refrigeration; about twice as large a per cent for household operation; and a slightly larger per cent for furnishings and equipment.

4. Corresponding to what is generally accepted as Engel's law with regard to "sundries," expenditures by families for reading, recreation, and education tend to be higher in relation to total expenditures on the higher levels of income than on the lower ones. Such expenditures are, however, reasonably stable in relation to total income.

Also within the framework of Engel's category on "sundries" are medical and personal care expenditures. Contrary to his laws, these expenditures

decline, both as a per cent of expenditures and as a per cent of income, as higher levels of income are attained.

5. Not specifically treated in this statement of Engel's laws are a number of other categories which are important to modern standards of living in this country. The proportions of income and of expenditures spent for tobacco decline with increases in income. Habit and limitations upon the capacity for consumption no doubt account for this situation. The proportion of total expenditures for transportation (mostly automobiles and their operation) tends to rise with increases in income, until the highest income class is reached. Not only are more expensive automobiles purchased by them, but more than one car may be operated and the vehicles are better serviced. In relation to total income, however, these expenditures rise from the lower to the middle-income groups and decline in the higher income classes.

From this brief analysis it appears that, in terms of total consumption expenditures, two of the four laws of consumption attributed to Engel, namely, those pertaining to food and shelter, hold good in the United States under modern conditions. A third law, the one dealing with "sundries," is true only in part, whereas the one dealing with clothing is not valid. If these laws are interpreted in terms of income, as has sometimes been done, Engel's laws pertaining to food and clothing are corroborated, but those pertaining to households and "sundries" are not.

An examination of the percentage of income spent by the various income groups for *all items* of current consumption reveals an important principle of our modern economy that was not a matter of careful study in Engel's day. The principle is that the *average propensity to consume,* which measures the percentage of total income at a given level that is spent for consumption purposes, *is considerably higher among the lower income groups.* Particularly in times of adversity, lower income groups must have their level of consumption supported by deficit spending or subsidies of one kind or another. *The average propensity to consume among the higher income groups is relatively low, while the propensity to save is high.* It is out of the savings of the higher income groups that the bulk of the funds is available for investment purposes, and such funds are necessary in order to expand the productive capacity of the economy. On the other hand, a high propensity to consume, at least among most of the population, is essential to a disposal of the goods and services flowing from the productive process. This suggests that a generally higher standard of living can come about only by increased purchasing power well distributed among the lower and middle income groups in the country without unduly interfering with the propensity to save on the part of the higher income groups.

Application of Generalizations on Family Income. The generalizations formulated above in regard to expenditure patterns by income level should

not be confused with principles previously presented in regard to total disposable income for the entire country.[10] For example, even though Engel's law with regard to food has been found valid in modern times, it does not follow that an increase in *aggregate disposable income* should inevitably result in a *lower national proportion* expended for food. Moderate annual changes in aggregate disposable income do not necessarily result in significant shifts in the proportions of families in different income groups. Some annual changes in income, when measured in dollars of current value, are due primarily to inflationary or deflationary tendencies. Changes in the size of the labor force or number of families are other factors. Broad social and economic trends also influence the aggregate amounts expended for major categories of consumption over time.

The generalizations stated within this section are used properly only for purposes of comparing the consumption pattern of families at different income levels—not for comparing aggregate expenditures for all families from one period of time to the next. Market analysts find such generalizations, and the data upon which they are based, particularly useful in determining the degree to which the markets for certain kinds of products are concentrated in certain income classes. For such purposes, it is very significant to know that per family expenditures for tobacco, while declining in relation to the size of income, are about three times as great in absolute amount at the "over $10,000 level" as they are at the "$1,000–$2,000 level."

Another useful application is in market area studies, as in evaluating trading areas of cities or of planned shopping centers. When local area levels of family income are determined, as may be done from Census data or other sources, the potential market for individual categories of consumption expenditures can be approximated much more accurately than from a knowledge of population alone.

Such generalizations are also useful in family budget planning. In preparing a plan for family spending, knowledge of the manner in which other families with similar income spend their money may be of value to many. They are also of value in determining how much is needed to support a family of a certain size in a given income status in matters of separations, divorces, and similar legal proceedings.

Changes in the Distribution of Family Income. Because of the foregoing established relationships between family income level and consumption, marketing executives are very much interested in average family income

[10] The degree to which Engel's Laws are useful in predicting total national expenditures for major categories of consumption has been tested empirically and found to be of little value for this specific purpose. See Benjamin S. Loeb, "The Use of Engel's Laws as a Basis for Predicting Consumer Expenditures," *The Journal of Marketing*, July, 1955, pp. 20–27. The authors have never made any such use of these laws.

and the distribution of income among all families. Considerable discussion is devoted to this question in a number of business periodicals. Unfortunately, many articles written on this subject leave a confusing picture and do not get to the heart of the truly significant question, namely, just what changes have taken place in the distribution of *real family purchasing power?*

Current analyses of income distribution must be interpreted with considerable caution. First, many of them discuss income in terms of income *recipients* rather than *families* which are the real spending units. Data are published annually by the U. S. Department of Commerce pertaining to the distribution of income by income groups for all recipients. An income recipient is any person who receives income. Since there are often several income recipients in a given family, such data are not particularly significant for explaining changes in family income. Second, most discussions of income are in terms of current dollars. For example, many articles have pointed out that there are, in a given year, more families in a particular income group (say, over $3,000 annual income) than in some former comparative year. Such statements may be of little significance because of price changes over a period of time which cause changes in the purchasing power of the dollar. Finally, as is shown below, it makes a great deal of difference whether such discussions are in terms of total personal family income before income taxes, or in the form of disposable family income that is available for current consumption.

Careful analyses of the distribution of disposable family income necessitate the use of elaborate statistical procedures. For this reason complete nation-wide studies are not carried on regularly. Furthermore, there is often a considerable lag between the undertaking of such a study and the publication of results. The data in Table 7, based upon one of the most thorough analyses of income ever made, provide a good indication of the manner in which the distribution of family income in the early 1950's differed from the distribution in the pre-World War II period. In this study, all consumer units (families and unattached individuals) were classified into five groups (quintiles) each containing the same number of consumer units, and arranged according to the size of personal family income. The first three columns of the table pertain to total family income before taxes, in current dollars. It may be observed that income in this sense increased by 102 per cent for all families between 1941 and 1950; that substantial increases were experienced by all income groups; and that the per cent of increase was greatest for the lowest income families, progressively decreasing with each succeeding income group.

In the second part of Table 7, statistical adjustments have been made to show disposable income in constant dollars. In 1950 the per family tax burden was nearly twice that of 1941, and this burden fell much more

heavily upon upper income groups in the form of progressive rates of federal income tax. At the same time, this period was characterized by inflationary price trends which cut the purchasing power of the dollar. After adjustments are made for taxes and price changes, the picture is considerably different. While total family income in current dollars increased by 102 per cent, actual purchasing power per family increased by only 17 per cent.

Of much greater marketing significance is the manner in which this increase was distributed among the consumer units. The rate of increase for families in the two lowest income quintiles was approximately five times as

TABLE 7

CHANGES IN AVERAGE FAMILY PERSONAL INCOME AND IN REAL DISPOSABLE FAMILY INCOME AMONG QUINTILES AND TOP 5 PER CENT OF CONSUMER UNITS,* RANKED BY SIZE OF FAMILY PERSONAL INCOME— UNITED STATES: 1941 AND 1950

	Mean Family Personal Income (in Current Dollars)			Mean Real Disposable Family Income (in 1950 Dollars)		
Quintile	1941	1950	Per Cent Change 1941 to 1950	1941	1950	Per Cent Change 1941 to 1950
Lowest	$ 450	$ 1,080	140	$ 750	$ 1,060	42
Second	1,044	2,444	134	1,730	2,360	37
Third	1,694	3,612	113	2,790	3,440	24
Fourth	2,463	4,971	102	4,030	4,690	16
Highest	5,396	10,197	89	8,190	8,880	8
Total	2,209	4,461	102	3,500	4,090	17
Top 5 Per Cent	10,617	18,250	72	15,040	14,740	—2

* Includes families (a group of two or more persons related by blood, marriage, or adoption, and residing together) and unattached individuals (persons who do not live with relatives).

Source: Selma Goldsmith, *et al.*, "Size Distribution of Income Since the Mid-Thirties," *The Review of Economics and Statistics*, February, 1954, Tables 4 and 14.

great as among those in the highest quintile. Purchasing power of the top 5 per cent of consumer units actually declined slightly. In general, the trend has been toward a considerably higher level of per family purchasing power, much more evenly distributed among all consumer units. While the most recent data in Table 7 pertain to 1950, data from samples of families reported in the 1955 Survey of Consumer Finances indicate that the distribution of pretax income was the same in 1954 as in 1950.[11] Since there were no material changes in tax rates by income levels between 1950 and 1956, the data on income distribution for 1950 may be considered typical as of the mid-1950's.

A number of circumstances have accounted for the greater equality of income distribution in the post-World War II period. Some degree of prewar

[11] See *Federal Reserve Bulletin*, June, 1955, p. 610 and p. 616.

inequality was due to unemployment or only partial employment of many members of the labor force. Postwar full employment conditions have removed most of this aspect of inequality. Second, there has been a modification in the occupational structure of the population, with a larger proportion of all employees engaged in skilled occupations or other kinds of work with higher incomes and a smaller proportion in common or itinerant labor. Third, wages and salaries of persons in the lower income occupations have increased at a greater rate than for people in the professions and other higher paid occupations. Fourth, the proportion of families with more than one wage earner increased by about 25 per cent between 1941 and 1951. In the latter year, about one-half of the families with incomes between \$4,000 and \$6,000 and about two-thirds of the families with incomes between \$6,000 and \$10,000 were multi-earner families, but only one-fourth of the families with incomes below \$3,000 had more than one wage earner. Obviously, many families in the so-called middle income groups would be in a much lower income group if the family were dependent altogether on the earnings of the family head.[12]

The shift to a greater equality of distribution at a higher level of family purchasing power has resulted in a more homogeneous market for consumer goods. It has brought about significant increases in *discretionary buying power,* i.e., income not required for the purchase of the basic necessities of life, especially in the middle and lower income groups. Thus, large numbers of such families have entered the market for many kinds of goods and services which were formerly regarded as luxuries to be enjoyed only by a few. Illustrative are many kinds of major household appliances, radios and television, second telephone extensions in homes, long distance phone calls, fashionable wearing apparel, better cuts of meat, wide varieties of fresh fruits and vegetables and prepared food products, and all kinds of lawn and garden equipment and supplies. For this reason, trends in average family income levels and distribution are observed with great interest.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:

a) production
b) income
c) consumption
d) gross national product
e) personal income
f) disposable personal income
g) income sensitivity
h) income elasticity of demand
i) price elasticity of demand
j) promotional elasticity of demand
k) "real" income
l) income recipient
m) discretionary buying power

[12] For a detailed analysis of these factors related to changes in income distribution, see Herman P. Miller, *Income of the American People* (New York: John Wiley & Sons, Inc., 1955), chap. ix.

2. What proportion of aggregate disposable personal income is ordinarily expended for current consumption? What usually happens to total consumption expenditures when disposable income increases or decreases? Explain.

3. What proportion of aggregate disposable personal income is usually accounted for by retail store sales? Are sales of durable goods stores or of nondurable goods stores more closely related to changes in disposable income? Explain.

4. Explain the significance of each of the following to executives of companies marketing, respectively, luxury goods and standardized goods of widespread demand:

   a) higher rates of personal income taxes for persons in higher income groups
   b) higher wage rates for industrial workers
   c) price supports or subsidy payments designed to improve the status of small-scale farmers
   d) liberalization of unemployment compensation programs
   e) more widespread acceptance of guaranteed annual wage programs
   f) liberalization of social security benefit programs

5. John Jones has been a supervisory employee in a small manufacturing company earning a salary that provides a disposable income of $275 per month. He has just accepted a much higher paying job in another company in the same community. He will now have $385 of money income after tax deductions per month. How is this increase in income likely to affect the proportions spent for clothes for his family? Food? Housing? Recreation? Automobile ownership and operation?

6. Is there any consistency in the pattern in which consumers, in the aggregate, spend their income according to broad categories of consumption? Explain.

7. What were Engel's Laws and how do they compare with modern experience in the United States? Do you attach any significance to the fact that Engel did not draw a clear distinction between expenditures and income? Does such a distinction have any bearing upon the degree to which Engel's Laws may be valid under modern conditions? Explain.

8. How do families in different income categories differ in regard to family characteristics other than income? Does this have any bearing on differences in expenditure patterns? Explain.

9. From the standpoint of marketing management, of what value are data pertaining to family expenditure patterns by income levels?

10. What major shifts have occurred in the distribution of real disposable income in the post-World War II years? How are these changes to be explained?

11. "X" was a small single-industry town of 20,000 inhabitants. With a returning period of prosperity and a consequent increase of wages among employees, the automobile dealers and the grocerymen of the town decided to put on a joint campaign to increase their sales. Should these two groups cooperate in this undertaking? Which is likely to be most successful? Discuss.

12. The head of an average-sized family earns $400 per month. If he budgets his income in line with average experience, approximately how much can he afford to pay for rent? For food? For clothing?

13. As market analyst for a large ready-to-wear chain, you are asked to study cities throughout the United States for the purpose of selecting desirable new store sites. You are given an adequate staff which will gather the information for you. Outline the pertinent factors concerning a city's *wealth* and *income* which you would like to have this staff obtain for you. Explain how you will use each piece of information, indicating its relative importance to this study.

6

WEALTH, CREDIT, AND OTHER CONSUMPTION FACTORS

Discussion of *the ultimate consumer* is concluded in this chapter with a treatment of wealth and credit as purchasing power and an explanation of custom and fashion as factors influencing consumer demand. As was explained in the preceding chapter, the disposable income of ultimate consumers is the most significant determinant of available purchasing power. Wealth and credit may, however, be used to supplement current buying income and thus may influence the *total amount of consumption expenditures* in any particular period of time. Furthermore, the accumulation of wealth and the existence of adequate and varied credit facilities affect the *character* of consumption expenditures, both currently and in the long run. Changing customs and social interest in fashion are additional factors that require examination in relation to consumption.

Wealth and Credit

Even though disposable income is of primary significance, wealth and credit are of great importance in relation to consumption expenditures and hence are subjects of considerable interest to economists and marketing executives. In the following sections, major emphasis is placed upon trends and variations in these factors as they relate to the extent and character of consumer purchasing.

Meaning of "Wealth." There are differences of opinion as to just exactly what constitutes wealth. There are further differences as to how wealth is to

be measured, whether in terms of physical resources or in terms of claims and rights. These differences are to a large extent dependent upon whether wealth is viewed as a social or national concept, or is considered from the standpoint of individuals.

Social or National Wealth. There is general agreement among economists that wealth, when considered from a social viewpoint, is synonymous with the nation's stock of economic goods. Economic goods are those which are the sources of services or satisfactions and for which people are willing to make sacrifices. They have capacities to satisfy human wants, but they are so limited in amount that we must economize in their utilization. Measurement of national wealth, then, requires identification of the nation's economic goods and determination of their value. Various serious, practical problems are encountered in any attempt at measurement, and these have given rise to different concepts of measurable national wealth which vary in degrees of comprehensiveness.

The broadest concept includes all material and nonmaterial economic goods. When goods have a material form, their identification is simple. There are many items, however, which do not exist in material form but which are economic nevertheless. Human skills and institutional arrangements are illustrative. The skill of a plumber or airline pilot, the business connections of a wholesale distributor, and the established organizational structure of a large manufacturing company are examples of items which have value because they are the source of services or satisfactions and yet are limited in amount. All items of this type must be included in any *comprehensive* measurement of the nation's wealth.

From a practical standpoint, however, it is not possible to compute a realistic monetary value for such nonmaterial resources. In fact, it is also practically impossible to value many kinds of material resources. This is especially true of land and natural resources which are not man-made and are limited in total supply. Changes in their total valuation, when such valuation is attempted, are often due to increasing scarcity rather than to an increasing supply, or to new techniques of measurement or new knowledge relating to the total available supply. Thus, when it comes to measuring wealth from a social viewpoint, it is often construed narrowly rather than comprehensively, being limited to man-made or reproducible material economic goods.

Individual Wealth. All social wealth is owned ultimately by individuals, either as individuals or as members of some collective group, such as a municipality, state, or nation. In the preceding discussion of social wealth, no mention was made of *instruments,* such as mortgages, promissory notes, stocks, and bonds, which are merely *claims* upon wealth rather than wealth itself. Such instruments are excluded from calculations of social wealth in

order to avoid the duplication that would result when, for example, a mortgage upon a house is counted as wealth and the house also is enumerated as a material economic good of given value including that of the mortgage. Similar duplication in social wealth computations would result if a corporate bond were counted, because the bond is merely a claim upon assets held by the issuing corporation.

From the individual's viewpoint, however, the term "wealth" need not be confined to the economic goods which are the ultimate sources of services or satisfactions; it may well consist of *all of an individual's net possessions external to himself,* including *claims* and *rights* to wealth as well as material goods to which he holds title. Since individuals have claims to the disposal of economic goods or the services of such goods, the measurement of wealth and its distribution may take the form of an evaluation of the claims of individuals. This is often more feasible than the measurement of the value of economic goods, because such claims usually have an identifiable form and can be more easily evaluated than the goods to which the claims appertain; but it involves much duplication and suffers from other basic shortcomings.

National Wealth Estimates and Total Consumption. The *total* wealth of a people is an important measure of the extent of consumption and its potentialities. As stated in a preceding paragraph, this has long been recognized by economists. Interest in the amount of national wealth in the United States has contributed to comparable estimates which extend over the course of the twentieth century. Estimates of the reproducible national wealth are presented in Table 8. They cover several categories of tangible assets which, for the year 1952, were composed approximately of the following: nonfarm residential structures, 25 per cent; other improvements upon real property, 28 per cent; producers' durable equipment, 16 per cent; consumer durable goods, 15 per cent; inventories, 12 per cent; monetary gold and silver, 2 per cent; and net foreign assets, 2 per cent.[1] Not included are data for land or unreproducible natural resources such as waterways, petroleum reserves, or mineral deposits. While these exclusions result in an understatement of the total social wealth, they probably do not substantially affect the general trend which may be observed from an examination of the data in the table. Very noticeable is the rapid growth in wealth which, in current dollars, increased more than 16 times in the first half of this century. Part of this increase is accounted for by higher price levels in more recent years. When wealth is considered in terms of constant dollars, as shown in the second column in the table, there was still about a four-fold increase. Even when the increase is considered in relation to population growth, the result is still impressive. During the first half of the century, the population of the country

[1] Computed from source indicated in Table 8.

just about doubled. Thus, reproducible social wealth in constant dollars increased twice as fast as population. This trend reflects a vastly larger capacity for production of goods and services to supply the expanded needs and wants of modern society.

A close relationship between social wealth and total consumption is apparent from comparisons of the wealth estimates in Table 8 and personal consumption expenditures previously given in Table 3. Such a comparison reveals that both series of data move in the same direction and, over a long

TABLE 8

ESTIMATES OF THE REPRODUCIBLE NATIONAL WEALTH—UNITED STATES: 1900–1952
(Billions of dollars)

Year	In current dollars	In constant (1929) dollars
1900	$ 59.1	$122.6
1905	76.5	146.2
1910	99.6	175.8
1915	126.9	202.6
1920	264.6	230.2
1925	272.9	275.3
1930	293.4	322.7
1935	256.1	297.1
1940	331.2	329.6
1945	441.5	331.5
1949	720.7	405.8
1952	968.4	475.7

Source Estimates by R. W. Goldsmith under auspices of the National Bureau of Economic Research, as published in the *Statistical Abstract of the United States, 1955*, Tables 368 and 369.

period of years, at about the same rate. For example, between 1930 and 1952 total personal consumption expenditures increased by 208 per cent. Over the same period, total reproducible wealth (in current dollars) increased by 230 per cent. Since a large part of the increase in total wealth represents an increase in the productive capacity of the nation, and since production is for the purpose of consumption, it is presumed that the accumulation of wealth contributes to higher levels of consumption.

The Distribution of Wealth and Consumption. While total wealth is an important factor affecting consumption, its *distribution* among the people exercises a much greater influence in determining *total* consumption and, especially, the nature of consumer demand. Unfortunately, there is a dearth of factual information concerning the distribution of wealth among individuals. Several studies conducted in the period between 1920 and 1940 indicated that the richest one-tenth of 1 per cent of the people owned more than 25 per cent of the wealth, that the richest 1 per cent owned between

50 and 60 per cent, and that the poorest 90 per cent owned but about 10 per cent of such wealth.

More recent statistics of a reliable character are not available for comparison, but two major factors lead to the conclusion that this extreme concentration has been significantly reduced. First, public policy since the 1930's has been directed somewhat toward a reduction in wealth concentration. High rates of taxation upon large amounts of personal income have made the accumulation of substantial wealth more difficult. Further, heavy death taxes on large estates are an impediment to the perpetuation of great individual wealth and hence favor more widespread distribution. Second, increasing amounts of real disposable income among middle income and lower income groups in recent years have made it possible for millions of people to support a reasonably high standard of living without using all of their income for current consumption. This has resulted in significant, although modest, accumulations of assets among a broader range of families. By midcentury, ownership of, or an equity interest in, a home had become commonplace. Families of ordinary means now have automobiles and many other durable goods. Ownership of corporate or government securities and savings accounts is a much more ordinary circumstance.

Possession of wealth influences personal consumption in a number of ways. The amount and character of a person's assets often determine his economic interests and influence his social position and obligations. Great wealth is a claim to substantial income resulting from the productive employment of wealth, thereby making it possible for the wealthy to enjoy a high standard of living which cannot be supported by work alone, and to do so without any impairment of the wealth itself. The wealthy, as a class, represent a market for luxurious clothing, housing and house furnishings, expensive automobiles, motor boats, travel, opera, objets d'art, and investments. Purchases of such luxuries as sable coats, costly jewels, and private yachts are a by-product of a marked concentration of wealth. A concentration of wealth in the hands of a small minority of the population not only creates a demand for luxury goods, but also sets standards in consumption which those of lesser wealth imitate. If the very wealthy build homes of modern design, the style is generally reflected in the homes of the less wealthy In fact, we may expect to see its adaptation to the housing needs of those of quite modest accumulations. Similarly, the desire of the wealthy for distinctive, custom-made clothing in a variety of designs furnishes an important source of ideas for the mass production company, which, in copying or adapting unusual features, destroys the unique character of the original model.

On the other hand, a wide distribution of wealth promotes social stability. Those who have a share in the wealth of a community are naturally conservative and reluctant to risk the effects of rapid change. The attitude

of the home owner as compared with that of the renter illustrates the stabilizing effects of accumulations. The renter may demand superficial changes and frequent repairs, whereas the home owner usually installs durable fixtures and equipment. During periods of economic stress, as in depressions, the owner of even modest wealth contributes a certain stability to the market. He can continue to make purchases on a conservative basis even though his income may be seriously reduced or temporarily eliminated.

Recognition of the general desirability of a widespread distribution of wealth has, unfortunately, led to a number of proposed political and economic so-called reforms designed to generate a high level of prosperity by an artificial and enforced redistribution of wealth. Such proposals have generally ignored the complicated nature of the modern production process in our economy. They reflect little evidence of understanding that a high rate of investment and incentives to make such investment are necessary in order that the economy may expand its level of production.

Liquidity of Wealth Held by Individuals. Probably of as great importance as the distribution of total wealth is the *form* in which the wealth held by individuals exists and the proportion of it that is liquid and thus more readily spendable. If substantial amounts are not only widely distributed among the people but are also in the form of government bonds, savings and checking accounts, or in stocks or industrial bonds which are readily convertible into cash, the effect on consumption is far greater than when such wealth is in real estate, farm land, industrial and commercial equipment, or in stocks of goods which must be maintained.

The total amount of *liquid* wealth and its distribution vary greatly with economic and other conditions. During periods of stress the total amount of such wealth is greatly diminished, and most of it is concentrated in the hands of a few, inasmuch as the limited accumulations of most people are rapidly exhausted. During periods of prosperity the total liquid wealth is increased and its distribution is more widespread, though not proportionally. In such periods consumer incomes tend to rise more rapidly than the rate at which consumers increase their expenditures. War and other periods of national emergency introduce another factor in the form of the purchase of government bonds, on the one hand, and the difficulty of securing durable consumer goods, on the other.

The significance of liquid assets to consumption does not lie merely in changes in *total* holdings but rather in changes in the liquid asset position of millions of families, some of which are adding to their holdings while others are using their assets for current consumption. Decreases in holdings are generally substantially more frequent among spending units that experience a decline in income than among those whose income remains the same or increases. *This means that families are more likely to draw upon their*

liquid reserves in order to maintain their standard of living than for purposes of raising it to a higher level.

Analyses of the purposes for which people use funds that are withdrawn from their liquid assets cast further light upon the relationship between the liquidity position of consumers and consumption. When consumers are asked why they accumulate assets, the traditional answer is that they do it in order to provide for "a rainy day." This is borne out by the most frequently reported use of funds withdrawn from holdings, which is to pay for family emergencies and sickness. This is only slightly more important than the use of such funds for the purchase of automobiles and other durable consumer goods. Other major uses in approximately the order of their importance are the following: nondurable consumer goods and service expenditures, particularly among families experiencing reductions in current income; repairs and additions to homes; luxuries and travel; home purchases; moving expenses; education; investment in assets not classified as liquid; use for farm expenses and investment in farm machinery; the repair of automobiles and other durable goods; and the payment of debts.

Conclusion with Respect to Wealth as a Factor in Consumption. It is apparent from the preceding discussion that the total amount of wealth, its distribution among the population, and the proportion of it in liquid form are important items related to consumption. A sound marketing principle issuing from this discussion is that *the greater the total wealth of this nation, the more widespread its distribution, and the larger the proportion in liquid form, the higher the level of consumption and the standard of living of its people.* This suggests the wisdom not only of endeavoring to increase the total wealth of this country, but also of attempting to attain a wider distribution through an increase in the productivity and earning power of those possessing little or no wealth, and furthermore, of striving to maintain a substantial proportion of the total wealth in spendable form. It is at least one way, in the long run, of sustaining or enhancing a large demand for goods and services for the general well-being of all inhabitants.

In view of the significance of wealth, it is unfortunate that more current factual data regarding it are not available. As previously stated, the estimation of total wealth is extremely complicated, posing many practical problems of valuation and coverage. The same is true of the distribution and concentration of wealth. About the only current information of value in demand estimation and policy formation in terms of the wealth factor consists of data on liquid assets of individuals as reported in the annual Survey of Consumer Finances in the *Federal Reserve Bulletin.* Such data are carefully observed by many marketing experts, for they provide some reflection of changes in wealth-distribution and indicate the purposes for which individuals have drawn upon their accumulations.

Credit in Relation to Consumption. *Credit is the power or ability to obtain goods or services or money in exchange for a promise to pay later.* For purposes of this discussion it is essential to distinguish consumer credit from government or business credit. Government credit is used by governmental units to carry on activities that are deemed to be in the interest of public safety or public welfare. Business credit is used by business firms to facilitate the productive process. Consumer credit, on the other hand, is used by individuals or families *for the satisfaction of their own wants.* The subject of consumer credit is treated in considerable detail in Chapter 26. For this reason, only brief discussion is intended at this juncture, and solely for the purpose of indicating the nature of relationships between consumer credit and consumption.

As has been indicated previously, at any given time an individual is said to possess purchasing power when he has income, wealth, or credit. Such acceptance of credit as purchasing power has led many people to conclude, quite erroneously, that an increase in the extension of consumer credit increases purchasing power. Actually, consumer credit arises out of purchasing power. The basis for such credit is the creditworthiness of the individual consumer, which means that the credit extended to an individual is limited by his normal or expected purchasing power. While credit does not per se actually increase purchasing power, it may increase, accelerate, or redirect spending or consumption. Thus, in the short run, expansion or contraction of credit may give the illusion of an increasing or decreasing purchasing power, especially if the error is made of confusing purchasing power with spending.

In examining the relationship between credit and consumption, regular charge accounts are to be considered apart from instalment credit. The latter type may be extended by the seller of goods or obtained by the consumer from a financial institution in the form of a loan which may be used to make a purchase.

Regular charge accounts are usually offered as a service or convenience to the consumer. The expectation is that payment will be made normally within about thirty days. Thus, except when the ordinary charge account privilege is abused, the consumer does not have the ability to buy anything which he could not buy for cash at approximately the same time. Charge accounts, therefore, do not have a very substantial influence upon the timing of purchases or upon the kinds of goods which are bought by consumers who use such accounts. It is rather well accepted, however, that such accounts have some influence upon purchasing. Persons with such accounts often have less sales resistance and are likely to spend more of their income for current consumption than would be the case if they actually had to pay cash for everything they bought. Furthermore, they are inclined to be more

quality conscious and less price-minded than consumers who buy on a cash basis.

The character of current consumption is much more affected by instalment credit arrangements. This type of credit makes it possible for consumers to buy kinds of things which they would not otherwise be able to purchase at the present and for which they would have to accumulate savings over a considerable period of time. Prior to 1915, instalment credit, except for real estate purchases, was practically nonexistent. The ownership of automobiles and other expensive durable goods was a luxury to be enjoyed only by the wealthy. As has been pointed out in the preceding chapter, more recent decades have been characterized by increasing levels of average family income, more evenly distributed among the population. This has given rise to significant amounts of discretionary buying power, much of which has been used for the purchase of durable goods, to a large extent financed by the expansion of instalment credit.

The popularization of instalment credit was a significant development during the 1920's; it was well established by 1930; and its use has greatly increased since that time. Between the Censuses of 1930 and 1950, the number of families in the United States increased by a little more than 40 per cent. Ownership of consumer durable goods increased at a much greater rate. For example, over approximately the same period, private automobile registrations increased by 75 per cent, refrigerators in use by about 900 per cent, and washing machines by about 340 per cent. While the increase in family income over this period may be adequate to explain the increasing and eventually commonplace ownership of durables which were formerly considered luxuries, it is not likely that consumers would have purchased all these items or in the same quantities if they had had to do so on a cash basis. The fact is that a very substantial proportion of such purchases is handled by means of instalment credit. About 60 per cent of new and used cars are purchased on credit. The importance of instalment credit for consumer durable goods other than automobiles is indicated by the extension of such credit by the stores that dominate the field. Approximately one-third of the total sales volume of consumer durable goods by department stores, mail order concerns, furniture stores, household appliance stores, and automobile accessory stores involves the extension of instalment credit.[2] In 1954, it was estimated that American families owned more than $135 billions worth of durable goods, excluding residences, and that the major portion of these had been acquired through instalment credit.[3] The preponderant majority of sales of residences is, of course, financed through a form

[2] "Consumer Instalment Credit," *Federal Reserve Bulletin,* September, 1954, p. 933.

[3] Clyde W. Phelps, *Financing the Instalment Purchases of the American Family* (Baltimore: Commercial Credit Company, 1954), p. 23.

of long-term instalment credit which is beyond the scope of the present discussion.

Further insight into the relationship between instalment credit and consumption is provided by a knowledge of the users of such credit. In 1955, 43 per cent of all families were making payments on some instalment debt, exclusive of real estate mortgages. The frequency of use is much higher or lower than this for certain groups. Users of instalment credit are highly concentrated in the middle income groups (with $3,000 to $7,500 annual disposable income). In lower and higher income groups the frequency of use is much less, in the first case because purchasing power is often inadequate to justify the extension of credit, and in the second because families have less need for it. By occupation groups, instalment credit is used much more by skilled and semiskilled workers and to a much less degree by the professional, managerial, self-employed, or farm operator groups, and retired persons. By family status, use of instalment credit is much more common among younger married couples with children than among single persons, married couples without children, or older married couples.[4]

From the foregoing, it is evident that instalment credit is utilized most liberally during the earlier years of family life, by families with adequate but limited purchasing power, and primarily for the purpose of acquiring a stock of durable goods which are needed to enhance the convenience and enjoyment of living. Such goods are not bought merely because they can be purchased on credit but also because they are wanted to support a standard of living that has become commonplace in this country. Through credit, millions of families are able to commit a portion of their future purchasing power and redirect their current outlays in order to enjoy now what they would otherwise have to postpone for a rather indefinite period or perhaps do without altogether.

The nature of the relationship between credit and consumption can be well appreciated by asking the question: What would happen if consumers could not buy automobiles, furniture, appliances and other durable goods through the use of instalment credit? Theoretically, it is possible that consumers would be able to save cash over a period of time and make the same purchases that they now make through the use of credit. Realistically, it must be remembered that the vast majority of consumers have tended to spend all or practically all of their income for current outlays on consumption. In the absence of credit, it appears rather certain that most families would use money now committed to the amortization of instalment contracts for various types of nondurable expenditures that would provide only immediate rather than lasting satisfactions. This has been rather clearly demonstrated in various periods during and following World War II when

[4] "1955 Survey of Consumer Finances," *Federal Reserve Bulletin,* June, 1955, p. 620.

the federal government controlled credit by tight restrictions upon minimum down payments and the maximum duration of instalment sales contracts. Such regulations seriously curtailed the sale of automobiles and other durable goods, sometimes resulted in the accumulation of inventories of such items on wholesale and retail levels, and gave rise to vociferous complaints and objections by merchants whose business was adversely affected and by consumers who were unable to buy the things that they needed and wanted.[5]

While credit does not, in itself, increase purchasing power but merely accelerates, increases, or redirects its use, it is widely accepted that it has an indirect effect upon total purchasing power by providing a greater incentive to work and earn income. The ease of owning durable goods increases the desirability of working harder and producing more in order to be able to pay for the items already possessed and yielding satisfactions. This encourages the heads of families to seek out occupations where they can make the greatest economic contribution and wives and other family members to enter into some form of gainful employment to increase family income.

Custom and Fashion

Habit and Custom. Habits and customs of consumers are powerful influences directing, limiting, and controlling demand. Habits relate to the practices of individuals. When particular habits are common to a considerable group of people, we have a social custom. Man is so constituted that he tends to develop more or less firmly established habits or fixed types of reactions. Originally, most of the things which we use in our daily lives were chosen as the result of careful selection either by ourselves or by others who were or are now in a position to influence us. Repeated selection of the same article has resulted in the formation of habits which, while greatly economizing our time and energy, are substantial barriers to change.

Customs exert a profound influence upon the consumption of social groups, sections, and nations. In certain parts of Europe, social customs result in the peasantry wearing costumes which differentiate them from other economic and social groups. Similarly, within the United States every section has some peculiar customs which distinguish its consumption from that of other areas. Many differences in customs among various social groups and regions are economic in their origin while others have a religious or climatic foundation. The practice of abstaining from meat on Friday and of fasting during the Lenten season is a custom of adherents to the Roman Catholic faith and influences the consumption of food products in varying degrees in different places according to the relative importance of members of this faith within the local or sectional population. Consumption of cigarettes, coffee, and carbonated and alcoholic beverages is relatively low in Utah, because

[5] The subject of regulation of consumer credit is treated in detail in Chapter 26.

the use of stimulants is prohibited by the tenets of the Mormon Church which has a very large membership in that state. It is customary for men to wear hats with relatively narrow brims (2¼ to 2½ inches) in the New England and Middle Atlantic states and hats with wide brims (3 inches) in the Southwest. Per capita consumption of soft drinks is about six times greater in Florida than in Vermont. New York City women use many times as large a quantity of cosmetics as do Vermont women. In New England there is an unusually heavy per capita consumption of tea, while in southern Louisiana per capita coffee consumption is at a high level. French traditions dominate the cuisine of New Orleans, while Milwaukee foods show the Teutonic influence. In the same way, New England colonial architecture contrasts with the Spanish designs of California.

Many local customs tend to perpetuate themselves while others are subject to rapid disappearance. Where differences depend upon such substantial bases as climate and economic need, they tend to persist. Where they are founded in geographical or educational isolation, they tend to disappear in these days of population mobility, high educational levels, large circulation of national magazines, motion pictures, and television.

Changes in social customs are frequently referred to as social trends. When the manufacturer or the merchant adapts his merchandise and services in such a way as to bring them into conformity with a social trend, he is likely to experience maximum success. When his efforts go counter to a fundamental social trend, they are doomed to failure.

Advertising and other sales promotional activities play their parts in the creation of fundamental consumer attitudes and social trends. However, there are elements in the social fabric and in the economic life of a people which play as important and, in many instances, far more important parts in determining fundamental social trends and in directing the consumption of social groups.

Fashion. People of all historical eras have been concerned to some extent with fashion. In other countries and in former generations in the United States, this interest was limited largely to the small proportion of the population that had the means to consume more than the basic necessities of life. Contemporary American living is characterized by an interest in fashion and style that seems to permeate the entire population.

In common usage, the terms fashion and style are synonymous. Technically, however, there is an important distinction. *Style,* according to one of the pioneering authorities on the subject, is *"a characteristic or distinctive mode or method of expression, presentation or conception in the field of art."*[6] In furniture, for example, one may speak of the Victorian or Regency

[6] P. H. Nystrom. *Economics of Fashion* (New York: The Ronald Press Co., 1928), p. 3.

styles or of such styles as Chippendale or Hepplewhite, the latter referring to two of the leading designers of furniture during the eighteenth century. *Fashion,* on the other hand, *is an accepted and popular style.* A certain style, therefore, may or may not be in fashion or fashionable at a given time. If the fashion is of relatively short duration, being accepted quickly and with exaggerated zeal and just as quickly disappearing, it is regarded as a *fad.* Ordinarily, only articles of the novelty type or matters of relatively unimportant style details are susceptible to faddist use.

Earlier in the century, discussions of fashion merchandising were confined almost exclusively to women's apparel. At that time, manufacturers and designers were much more successful in securing acceptance of their style creations by their own efforts than they have been since that time. For example, manufacturers of women's clothing would meet in conventions and reach an agreement as to the general character of apparel design for the forthcoming season. Merchants had little alternative to purchasing these designs, and the consuming public showed great docility in their acceptance. In later years, the consumer has shown no hesitancy in rejecting offerings, and the plans of manufacturers and merchants have frequently met with ignominious failure.

In present-day America, fashion is almost universal. It is to be found not only in all women's wearing apparel but also in men's clothing and furnishings. It is equally present in furniture, home furnishings, automobiles, homes, modes of public transportation, foods and beverages, and in such personal services as hairdressing and manicuring. In fact, practically every phase of human consumption has been touched by the wand of fashion. Moreover, fashion is of importance in the choice of the store from which such goods are bought. In purchasing style goods, consumers generally prefer to make comparisons of the offerings of several stores before making a final selection. That has been an important factor in the development of shopping districts in our cities and in the growth of city stores at the expense of the smaller town competitors.

With improvement in our economic well-being and constantly rising standards of living has come about a growing emphasis on fashion. Fashion consciousness has been further stimulated by the greater mobility of our population, largely over hard surface roads by automobiles, the motion picture, wider periodical and newspaper circulations, and the greater fashion awareness of our retail merchants.

Fashion change is, therefore, an accepted fact of our economy. The trend has been for a larger element of fashion in practically all goods we consume and services we use and for more rapid changes in fashion. The same factors that accounted for growing emphasis on fashion as a whole have been responsible for acceleration of the fashion tempo.

The Fashion Cycle. The matter of style change is of increasing importance not only to consumers, but also to manufacturers and distributors, including retail merchants. Unforeseen changes in style and failure of particular styles to attain vogue, and hence to become fashions, may certainly result in severe losses to businessmen. Outmoded or unacceptable merchandise may become absolutely unsalable or disposable only at prices which result in heavy losses. It becomes essential, therefore, for businessmen to gain a proper understanding of the circumstances under which fashions are created, placed on the market, bought by consumers, and finally abandoned. The several phases through which a fashion passes represent what is generally known as the *style or fashion cycle,* the term "cycle" having reference not to the *repetition* of the same phases to a given fashion but to the wavelike regularity of movement that generally characterizes a fashion.

If a style is widely enough accepted to become a fashion. its history, cycle, or curve is marked by the following *stages or phases:* creation, showing, adoption, adaptation, popularization, mass production, and abandonment. From the standpoint of consumer reaction, the cycle or curve is characterized by the stages of adoption by style leaders, followed, in order, by first imitators, white collar masses, lower income groups, and finally by those on the subsistence level. The fashion cycle may be portrayed by a simple curve of a wavelike nature showing the point of inception, the point of greatest popular acceptance of the product, and the point of termination or abandonment. If another curve representing use, rather than purchase, of the product is placed on the same chart, it will be found that the point of greatest use is far beyond the point of largest purchases and that the use extends considerably beyond the point of abandonment. Stated otherwise, people continue to use a fashion article long after they refuse to purchase the identical product in replenishing their wardrobes.

The fashion cycle is operative both with respect to *general fashions,* a term sometimes used to identify long-range fashion trends, and to *specific fashions,* a term pertaining to the popularization of various individual styles within a general fashion trend.[7] For example, in recent years the growing consumer preference for sportswear and casual clothing was a general fashion of enduring significance. On the other hand, consumer preference for white instead of red sweaters as an item of sportswear may be a specific fashion of only seasonal importance. Similarly, in the years of the early 1950's, there was an important general fashion trend in men's suits manifested by consumer preference for single rather than double breasted garments, and with a narrower, trimmer, less padded appearance than was formerly popular. Within this trend, specific fashions varied considerably from season to season, as evident by the widespread demand for three

[7] Cf. Alfred H. Daniels, "Fashion Merchandising," *Harvard Business Review,* May, 1951, pp. 51–60.

button, charcoal gray suits for a time and a shifting to preferences for lighter colors with various design modifications on other occasions. While general fashions may enjoy a long period in the "mass production" phase of the fashion cycle, specific style numbers may move through the various phases of the cycle with such rapidity that they almost become a blur.

Attempts to popularize any new specific style are always experimental. No one can say with absolute assurance that it will have any wide acceptance. This is true, whether the style relates to clothing, housing, home furnishings, automobiles, or food. The motif or idea underlying a new design or style may originate in such a cataclysm as war, outstanding events in the field of exploration, political upheavals, a certain part of the world coming into prominence, an outstanding play or motion picture, or in some action of an individual upon whom public attention is focused. In other words, the creation must express something—a trend, fact, or thought—that is prominent in the public mind.

The creation is followed by a showing of the new fashion, the purpose of which is to test out public response. New designs in women's apparel may be brought before well-dressed women by the use of manikins. Usually, showings are held by the designers at their salons for the benefit of buyers from stores and others in accordance with published announcements in leading periodicals. Furniture is exhibited at World Fairs and at such centers as Chicago and Grand Rapids at regular intervals. Showings may also be accomplished by the production of small quantities of the new style and its display by stores catering to a wealthy clientele. Of the many styles created, only a minority are ever widely enough adopted to become fashions.

If the new style is adopted by well-to-do purchasers in the large fashion centers such as Paris, New York, or Hollywood, it may become very popular and spread throughout the country with great rapidity. Its wide acceptance will be accompanied by large-scale production and the style, first shown in models of very high unit price, will be immediately copied and adapted by producers of popular and low-priced merchandise.

The Marketing of Fashion Merchandise. The introduction of style elements into merchandise where style was formerly negligible, the increased emphasis upon style, and the shortening of the fashion cycle have added greatly to the cost of producing and distributing goods. Manufacturers frequently misinterpret consumer reactions and suffer severe losses which must be compensated for in the prices received for those styles which meet with wide acceptance. Merchants are forced to buy more frequently and in smaller quantities, and their risks on account of style obsolescence are greatly increased. Consumers must pay a higher price as a result of constant change in styles and because they seem to be ruled by fashion.

Whether or not consumers get value received in consequence of the rapid fashion changes and whether this is in the public interest are often debated,

but it is a subject beyond the scope of this immediate discussion. There are, however, certain statements that can be made almost categorically and in the nature of principles that have been derived from a study of the subject over many years, as follows:

1. *A new style conception cannot be forced upon the consuming public as a fashion unless the conception or design is attractive to a large segment of the population.* For example, purchases are not made by buyers for retailing organizations, the interpreters of local consumer demand, unless they are reasonably certain that the consumers will buy what *they* buy for resale.
2. *The higher the standard of living, the greater the mobility of the population, and the more widespread the interchange of information, the greater the emphasis upon fashion.*
3. *The greater the emphasis upon fashion and the shorter the fashion cycle, the higher the costs of producing and distributing goods.*

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   a) wealth
   b) social wealth
   c) individual wealth
   d) reproducible wealth
   e) credit
   f) consumer credit
   g) custom
   h) style
   i) fashion
   j) fad
   k) fashion cycle
2. Assume that you are an economist who has been assigned the task of estimating the total amount of wealth in the United States. Assume, further, that you have a large staff of well-trained technicians and adequate funds. What would be the major problems that you would encounter in such an undertaking? Explain what you would include and what you would exclude and how you would determine values for the items included.
3. How is the concept of wealth, when considered from the standpoint of an individual, different from the social concept of wealth?
4. Why is a mortgage bond, issued by Company A to Mr. B in the sum of $1,000, wealth to B but not to society at large? Explain.
5. Data show a close relationship between total wealth of the nation and total personal consumption. Does this necessarily mean that this is a cause and effect relationship? Explain.
6. In what way does the consumption of goods by the wealthy affect the consumption by the less well-to-do? Is every businessman equally interested in the way in which the wealthy spend their money for goods and services? Explain.
7. Of what significance are the liquid asset holdings of individuals and their distribution among spending units? Answer this question from the standpoint of an executive in each of the firms manufacturing: major electrical

appliances, automobiles, infants' clothing, staple food products, fancy food products, nonalcoholic bottled beverages.

8. Is it likely that the distribution of wealth among individuals has become more highly concentrated or more widely dispersed since the 1930's? Give two major reasons for your answer.
9. If an individual has a good credit rating, is his purchasing power greater than his income? Explain. Is the same thing true of his spending?
10. The proportion of total consumer purchases made on charge accounts is about twice as large as the proportion handled by means of instalment credit. Does this indicate that regular charge accounts are more important as a factor affecting consumption? Explain.
11. If the federal government would place severe restrictions upon the use of instalment credit, how would this affect total consumer purchasing power? Total consumer spending? The character of consumption?
12. What kinds of people are the most common users of instalment credit? Does this suggest any important reason for the use of this type of credit?
13. Do habits and customs play as important a role in consumption today as they did 50 years ago? Is it to be expected that they will increase or decrease in importance during the next 50 years? Explain.
14. State and explain the various stages in the fashion cycle. Do the same stages apply to a fad?
15. How is emphasis upon fashion related to the cost of manufacturing and distributing merchandise? Explain.
16. Do sellers, through successful sales promotional devices, *create* a demand for certain styles, thus causing these styles to become high fashion; or does consumer demand dictate the styles which will be produced, promoted, and sold in large quantities? In what way, if any, would this situation differ in a socialist commonwealth?

III

OUR RETAILING SYSTEM AND ITS PERFORMANCE

7

THE RETAILING STRUCTURE

Upon recognition of a need for merchandise, it is conceivable that the consumer-buyer of today would seek to make contact with the grower or manufacturer of the goods. The fact that he does not do so, except under rather unusual circumstances, suggests very strongly that he finds it more convenient and economical to patronize one of the various kinds of retailing institutions that have evolved to bridge the temporal and spatial gap between the creation of form utility and ultimate consumption. Similarly, the fact that farmers and manufacturers do not ordinarily seek to sell directly to consumer-buyers is evidence that a larger volume of more profitable sales can be obtained by utilizing the facilities of our specialized institutional structure for retailing.

The task of the present chapter is that of viewing the retailing structure broadly. This is done by giving attention to the over-all importance of retailing; by outlining various major classes of retailing institutions and indicating, to the extent possible, the quantitative importance of each; and by examining the degree to which retailing institutions have adapted their operations to a dynamic environment. In the following chapters of Part III, a detailed analysis is made of the performance of certain specific institutions which are of unusual interest or importance.

Retailing Concepts. The terms "retailing," "retailer," and "retail store" are commonly used in popular speech in an interchangeable manner. Yet the average layman is hard pressed if asked to state specifically what it is that sets retailing apart from other business activity. Several questions may be raised to indicate the confusion that prevails. Is a sale a retail sale because it was consummated in a retail store? Or, is a store retail in character because it engages in a particular kind of business? Does a retail sale nec-

essarily involve a small quantity of goods, a higher price than in a wholesale transaction, or a particular kind of merchant who effects the transaction? When a consumer makes a purchase in a store, is the clerk behind the counter a retailer, or is this term more properly used to refer to the firm represented by the physical facilities in which the transaction is consummated? Are the activities of retailers synonymous with retailing, or is retailing also carried on by others? When a consumer buys from a business firm claiming to be a wholesaler, and when the consumer, by so doing, obtains a price lower than the ordinary retail price, is the consumer purchasing at retail or wholesale?

The variety of answers to such questions that may be expected from persons who have not heretofore given careful study to their implications points to the need for considering the meaning of important retailing terms as they are authoritatively recognized. Carefully formulated definitions are a prime necessity for purposes of meaningful discussion and analytical study, for proper classification of quantitative data pertaining to retailing, and for various legal purposes, including matters of taxation and coverage of establishments under wage and hour legislation, which are discussed in Chapter 13.

Stated most simply, *retailing* essentially involves selling at retail. Among authorities who have given the most serious study to the question, there has developed the consensus that the only clear, meaningful, and sound criterion for distinguishing retailing from other business activity is the *status or motive of the purchaser.* Thus, *a retail sale is one in which the buyer is an ultimate consumer,* as opposed to a business or institutional purchaser, *and the motive is personal or family satisfaction stemming from the final consumption of the article being purchased,* in contrast with purchases for resale or for business, industrial, or institutional use. It is, however, impractical to obtain data pertaining to the total of such transactions. Insurmountable difficulties would be encountered in distinguishing retail sales from sales to business firms when a business user of a commodity makes a purchase of a small quantity of an item in a regular retail store and at the same price as paid by the ultimate consumer; consequently, such sales to business users are usually regarded as retail in character.

It is the composite of the transactions made by an establishment that gives it its principal character. A *retail establishment* may, therefore, *be defined as a single or separate place of business, principally engaged in the performance of marketing functions, wherein or out of which sales are made primarily to ultimate consumers.* In borderline cases such as are encountered in attempts to classify split-function establishments (i.e., those that sell partly at retail and partly at wholesale), the classification is usually effected on the basis of the rule of more than 50 per cent of the dollar volume of business. Thus an

establishment is considered as retail if more than one-half of its dollar volume of business consists of sales to ultimate consumers.[1]

Most retail establishments are *retail stores*. These are places of business *which are open to and frequented by the general public, and in which sales are made primarily to ultimate consumers, usually in small quantities, from merchandise inventories warehoused and displayed on the premises.* Some retail establishments are operated by *nonstore* retailing organizations. The major types in this category consist of mail order establishments, offices that serve as headquarters for house-to-house selling companies, and facilities from which vending machine operators conduct their businesses.

Any individual or any type of business organization can own and operate a retail store or a retail establishment. The very great majority, however, are operated by retailers. *Retailers are merchant middlemen who are engaged primarily in selling to ultimate consumers.* Unlike manufacturers or farmers who may operate retail establishments, retailers specialize in retailing activities. They stand in the channel of distribution between manufacturers, farmers, or wholesale middlemen and ultimate consumers; they buy and assemble stocks of merchandise which they own and hold at their own risk and attempt to resell them at a profit.

From the foregoing discussion, it is evident that different conceptions underlie the proper use of the terms *retailing, retail establishment, retail store,* and *retailer*. Retailing, in the broadest conception, *is the activity of selling to ultimate consumers for personal or household consumption.* While most of this activity takes place through the operation of stores, it may be engaged in by anyone—for example, a farmer selling fresh vegetables door-to-door, a wholesaler selling to an acquaintance for the latter's personal use, or a manufacturer selling direct to consumers by mail are all selling at retail. Such retailing activities are not included within the scope of operations of retail establishments, which constitutes the basis for all Census of Business data presented in later sections of this part of the text. On the other hand, it must be recognized that many retail stores make some sales which are not retail in character, but which are essentially wholesale because the goods are purchased by businesses for purposes of resale or for business use. Most retail stores are operated by retailers, merchant middleman selling primarily to consumers, but this is not universally the case. Some stores are owned and operated by manufacturers rather than by retailers. One must

[1] The definition of retail establishment here given is more explicit but reasonably in line with that used in the U. S. Census of Business. For Census purposes certain exceptions are made because of traditional practices within particular lines of trade. Farm equipment dealers and stores selling office equipment and office furniture are examples of establishments that sell primarily to business users, but are classified as "retail" within the Census. Such departures from a consistent criterion for classification are deplored by the authors of this text, because they result in the compilation of less sound and certainly less homogeneous retail trade statistics than would otherwise be provided.

recognize and keep in mind, therefore, that there are important theoretical and practical differences among the sum total of retailing, the sales volume of establishments as enumerated by the Census, and the operations of retailers.

Economic Basis of Retailing. The retailer occupies an important place in our economic life. As the last link in the channel of distribution next to the consumer, his is the task of performing the final functions involved in delivering to the public its standard of living. Certain long-run trends have operated to make the retailer increasingly important as our country has become more mature in its industrial organization. One has been an increased separation between manufacturer and consumer. Another is the specialized manufacture of thousands of articles used in our daily life which is based upon technical division of labor and an advanced knowledge of technological processes. A third factor has been the tendency over the years to depend upon outside rather than home production as exemplified by the decline of home baking and sewing.

Productive Character of Retailing. Retailing organizations add values to the commodities they distribute principally through the creation of place, time, and possession utilities and, to a limited extent, by the creation of form utility. Place utility is added by bringing goods from concentrated supplies in wholesale markets to retail stores which are conveniently accessible to consumers and, in some cases, by providing delivery service to consumers. Time utility is provided by anticipating consumer wants and storing goods from time of receipt until time of consumer purchase. Retailers make a substantial contribution to possession utility by transferring the ownership of goods from business organizations that have no use for them other than trading, to ultimate consumers for whom value in use is high. Many kinds of retail stores engage in form utility production as is illustrated by food preparation in eating places, prescription compounding in drugstores, meat preparation and packaging in food stores, and the operation of drapery and clothing alteration workrooms in department stores. For the most part, however, the creation of form utility by retailers is incidental to the retail sale of commodities rather than the principal attribute of the organization.

Marketing Functions Performed by Retailers. In the process of creating such economic values, retailers perform all of the eight marketing functions. The relative importance of individual functions tends to vary with the type of goods handled by a particular store and with the degree of service rendered to customers.

Buying is an important service of all merchants since they serve as purchasing agents and assemblers for their customers. This may be relatively simple or exceedingly complex. Some small appliance stores without repair

service departments may have fewer than twenty different merchandise items in stock, and all of these may be obtained from one or two local wholesale distributors. In a modern supermarket, there may be found as many as 3,000 or 4,000 different items[2] purchased or assembled from several hundred manufacturers and wholesale middlemen in several closely related trade classifications. At the extreme, a few large department stores carry more than 1,000,000 different items in a wide variety of departments, and their buyers assemble the merchandise from thousands of sources in almost all trade classifications of consumer goods wholesaling and manufacturing.

Selling is an indispensable part of every transaction and is the basic reason for the operation of stores. In stores that sell merchandise of high unit value which is purchased infrequently by the consumer, major reliance is often placed on personal selling activities so that the product line can be interpreted to the consumer and so that selling can be adapted to circumstances that vary appreciably among individuals. Almost all classes of stores engage in some form of advertising activity. Those that sell predominantly convenience or standardized goods tend to rely heavily upon nonpersonal selling effort, making sales from visual displays of familiar merchandise.

The significance of the *transportation function* varies considerably among different classes of stores. Small retailers in convenience goods lines tend to rely upon wholesalers for long-distance spatial movements from farms or factories to the local market and from the wholesaler to the retail store. Large retailers, especially chain store and department store organizations, often arrange for transportation of merchandise from distant sources of supply to their local warehousing facilities, and operate their own transportation equipment to accomplish the movement of goods from warehouses to individual stores or selling departments within stores. Consumers have tended to assume the transportation function in store-to-household movements of merchandise, as the ownership and use of automobiles has increased and retail trade has become more decentralized within major metropolitan areas. Delivery service remains of great significance, however, for stores that serve a large trading area or sell heavy or bulky merchandise. This is accomplished through a variety of means, including individual store delivery equipment, consolidated parcel delivery companies, and public transportation agencies such as parcel post, railway or air express, and motor and rail freight.

The historical significance of the *storage* function is suggested by the designation retail "store." In an early era, when transportation and communication services were slow and uncertain, the major function of retailers was that of maintaining a storehouse of merchandise, replenished by infrequent

[2] Counts of merchandise items customarily include each aspect of a merchandise assortment that must receive separate attention in buying, stock arrangement, and selling. For example, each can size of each variety of each brand of canned fruit would be counted as an individual merchandise item.

purchases of large quantities out of which consumer needs were served as they arose from day to day. Modern developments have tended to place more stress upon the retailer's role as a distributor or seller rather than as a storer of goods. Storage remains a key function, however, and its importance varies among stores somewhat in relation to rates of stock turnover.[3] Common rates of turnover vary among lines of trade in relation to the type of merchandise handled, accessibility to sources of supply, and traditional buying practices. Inventories stored in meat markets usually are the equivalent of only about one week of sales; in department stores, stocks on hand ordinarily represent an investment of about three or four months' sales volume; in jewelry stores, inventories in certain lines of merchandise may be as much as the annual volume of sales in those lines. The significance of storage varies also with the kind of special facilities provided for the care or preservation of merchandise. While turnover rates are very high in food stores, much special-purpose storage equipment is needed. In a modern supermarket there is often as much as 100 running feet of frozen food display equipment which represents an investment of tens of thousands of dollars.

The relative importance of the four facilitating functions presents a mixed pattern. Many large retailers are very concerned with *standardization* in that they set product specifications for many items which are manufactured or packaged under their own brand names. Food stores often pre-package meat and fresh fruits and vegetables in standard units of sale. Some retailers confine their *financing* activities to providing an investment in fixtures, equipment, and inventory; but this is often supplemented to a substantial degree by credit arrangements with wholesalers, manufacturers, and financial institutions. The retailer is thus actively engaged in financing purchases by ultimate consumers through the extension of regular charge account and instalment sale credit. Many department stores, furniture stores, jewelry stores, automobile dealers, and specialty apparel stores sell predominantly on a credit basis. Since retailers are merchant middlemen, they must assume the *risk* associated with the ownership of the various assets of the business, including receivables and merchandise inventories. This is especially hazardous in fashion merchandising where the wants of consumers change with the seasons and often within seasons. Every retailer must analyze the needs of consumers by collecting and interpreting *marketing information* if his merchandise offerings are to be in harmony with their buying wants and the goods are not to stagnate upon his shelves.

The degree to which the total performance of any given marketing function is assumed by the retailer, is divided among other marketing institutions, or

[3] By stock turnover is meant the number of times during a year that the average value of inventory is turned over in terms of sales. It is computed by dividing sales by average inventory, with both stated in comparable valuations, either cost or selling price.

is assumed by consumers through self-performance of marketing activities, varies from time to time and with different kinds of business. The costs incurred and the values contributed by retailers thus shift from time to time, as some of the functions increase in importance and others decrease. Better credit-granting technique has reduced bad-debt losses and other costs of financing the consumer. The widespread and increasing use of the self-service method of operation has reduced the direct selling costs of stores which have adopted that plan. There are reasons to believe that such functions as transportation, financing, and personal selling may assume permanently lower relative proportions of the total costs of retailing. But this can be done only if the consumer is willing to continue to perform some of these functions himself, in part at least. If he is not willing to do so, he will expect the retailer to perform them for him and should be willing to pay for the performance of these functions. Doubtless the final answer will vary from consumer to consumer and from store to store, and no doubt also with the line of merchandise.

Total Retail Trade Structure. Some appreciation of the magnitude of the total retail trade structure and changes therein may be gained from a consideration of the dollar and physical volume of sales of all retail establishments, as related to trends in population growth and in number of stores in operation.

Volume of Sales. Total annual sales of retail stores vary greatly with business conditions. In 1929, a prosperous year of the period, they amounted to $48 billions; but 10 years later, when business conditions were nearer what was thought of as normal for those times, retail sales were only $41 billions. In 1954, a very prosperous year, such sales attained the unprecedented level of $170 billions, more than four times the 1939 prewar level.

To be sure, much of this variation is attributable to changes in the price level rather than to changes in the physical volume of goods distributed through retail stores. When total store sales are adjusted by an index of retail prices and are expressed in dollars of constant value, as shown in column (3) of Table 9, it is revealed that the physical volume of sales was actually 6 per cent lower in 1929 than it was in 1939 and that 1954 sales were only 92 per cent above those in 1939. While the latter is a much smaller increase than recorded in current dollars, it is nevertheless evident that in 1954 the retailing structure effected the distribution of goods in physical quantities never anticipated under conditions prevailing prior to World War II.

An appraisal of the extent or trend in retailing business over a period of time must take into account changes in the population of the country. When the physical volume of trade is expressed on a per capita basis, as indicated in column (5) of Table 9, a somewhat more stable situation is apparent. In 1929 and in 1939, there was very little difference in the physical volume of goods sold per capita. The somewhat higher total physical volume of sales

in 1939 was offset by the fact that there was an increase of population between these two years that amounted to about 9 million inhabitants. Similarly, between 1939 and 1954, the increase in the physical volume of sales was partly offset by substantial population increases. The physical volume of retail sales *per capita* was nevertheless about 57 per cent greater, under the conditions of unprecedented civilian production and purchasing power that prevailed in 1954, than it was in 1939.

TABLE 9

DOLLAR AND PHYSICAL VOLUME OF SALES OF RETAIL ESTABLISHMENTS AND PHYSICAL VOLUME PER CAPITA—UNITED STATES: CENSUS OF BUSINESS YEARS, 1929–1954

Year	Actual Sales in Current Values (millions) (1)	Retail Price Index: 1954 = 100 (2)	Physical Volume of Sales (in 1954 Dollars) (millions) (3)	Population (millions) (4)	Physical Volume of Sales Per Capita (in 1954 Dollars) (5)
1929	$ 47,769	58.0	$ 82,360	121.9	$ 676
1939	41,445	47.5	87,253	131.0	666
1948	128,849	92.4	139,447	146.6	951
1954	169,968	100.0	169,968	162.4	1,047

Sources:

(1) U. S. Census of Business for the respective years. Data for 1929 revised to exclude automotive service establishments; and data for 1929, 1939, and 1948 revised to exclude retail milk dealers that operate bottling plants, both of which are beyond the scope of present Census coverage. Method of enumeration in the Census of 1954 also varied somewhat from previous procedures, resulting in reduced coverage of the smallest stores without payroll. Data for 1948 were retabulated for comparability with 1954, but this was not done for 1929 and 1939. The differences involve a small per cent of the total number of establishments and but a minute fraction of the total sales volume; hence they do not have a substantial effect upon the comparisons here presented.

(2) U. S. Department of Commerce Index of Retail Prices from "Business Statistics" supplement to *Survey of Current Business*, 1955 Biennial Edition, p. 26. Adjusted by the authors to the base of 1954 = 100 from 1947–49 = 100.

(3) Data in column (1), divided by data in column (2) × 100.

(4) Bureau of the Census for inter-decennial years, as published in "Business Statistics," *op. cit.*, p. 56.

(5) Data in column (3), divided by data in column (4).

Number of Establishments. In 1929, the total number of retail establishments was a little under 1.5 million, whereas in the years 1939, 1948, and 1954, it has been about 1.7 or 1.8 million (see Table 10). While varying somewhat from year to year, the number of stores has been much more stable than sales volume, whether measured in current dollars, constant dollars, or sales per capita. During the decade of the 1930's, when the nation experienced its worst period of depression, the number of stores increased, but in the following 15 years, marked by war conditions and high levels of prosperity, there was very little change in the number of retail stores, even though the physical volume of goods distributed increased substantially. When economic conditions are adverse, as they were in the early 1930's, sales per store decline and more retailers go out of business. They are more

than replaced, however, by new retailers anxious to eke out a living by operating a small store. When economic conditions are good and vocational opportunities are ample, it appears that fewer new stores are established.

In recent years the trend has been for a great increase in the scale of retail store operations, especially in the food field and to some extent in most lines of business. The physical volume of sales per establishment in 1954 was approximately twice that of the 1939 level (see Table 10). Such a development has contributed to enhanced efficiency in the utilization of personnel and capital resources in the typical establishment.

TABLE 10

NUMBER OF RETAIL ESTABLISHMENTS AND PHYSICAL VOLUME OF SALES PER ESTABLISHMENT—UNITED STATES: CENSUS OF BUSINESS YEARS, 1929–1954

Year	Number of Establishments (1)	Physical Volume of Sales (in 1954 Dollars): Total Amount (millions) (2)	Per Establishment (3)
1929	1,472,377	$ 82,360	$55,937
1939	1,760,903	87,253	49,550
1948	1,668,479	139,447	83,577
1954	1,721,650	169,968	98,724

Sources:
(1) See note (1) to Table 9.
(2) From Table 9, column (3).
(3) Data in column (2), divided by data in column (1).

CLASSIFICATION OF RETAIL STORES

The same term, retail store, is used to refer to the vast R. H. Macy and Company department store in New York City and to the smallest cigar and newsstand operated in the lobby of a public building. Between these two extremes are to be found most of the retail establishments of this country. Some are exceedingly small; others are so vast as to make possible annual sales greatly in excess of $100 millions in some of the largest department stores. The very existence of such a varied structure of retail institutions limits the extent to which it is possible to generalize about the totality. For a proper understanding and evaluation of this retailing structure and changes therein, it is essential to break it down into significant component parts through meaningful classifications, each of which may be studied by itself and in comparison with other segments of the structure with which it comes into competitive conflict or which may be deemed as socially or economically desirable alternatives.

It is possible to classify retail stores in an almost unlimited variety of ways, as illustrated by the outline of various alternative bases for classifica-

A. By *Ownership* of Establishment:
   1. Single-unit independent stores
   2. Multi-unit retail organizations:
      a) chain stores
      b) branch stores
   3. Manufacturer-owned retail outlets
   4. Consumers' cooperative stores
   5. Farmer-owned establishments
   6. Company-owned stores (industrial stores) or commissaries
   7. Government operated stores (post exchanges, state liquor stores)
   8. Public utility company stores (for sale of major appliances)

B. By *Kind of Business* (Merchandise Handled):
   1. General merchandise group:
      a) department stores
      b) dry goods, general merchandise stores
      c) general stores
      d) variety stores
   2. Single-line stores (e.g., grocery, apparel, furniture)
   3. Specialty stores (e.g., meat markets, lingerie shops, floor coverings stores)

C. By *Size of Establishment:*
   1. By number of employees
   2. By annual sales volume

D. By Degree of *Vertical Integration:*
   1. Nonintegrated (retailing functions only)
   2. Integrated with wholesaling functions
   3. Integrated with manufacturing or other form-utility creation

E. By Type of *Relationship With Other Business Organizations:*
   1. Unaffiliated
   2. Voluntarily affiliated with other retailers:
      a) through wholesaler-sponsored voluntary chains
      b) through retailer cooperation
   3. Affiliated with manufacturers by dealer franchises

F. By Method of *Consumer Contact:*
   1. Regular store
      a) leased department
   2. Mail order:
      a) by catalog selling
      b) by advertising in regular media
      c) by membership club plans
   3. Household contacts:
      a) by house-to-house canvassing
      b) by regular delivery route service
      c) by party plan selling

G. By Type of *Location:*
   1. Urban:
      a) central business district
      b) secondary business district
      c) string street location
      d) neighborhood location
      e) controlled (planned) shopping center
      f) public market stalls
   2. Small city:
      a) downtown
      b) neighborhood
   3. Rural stores
   4. Roadside stands

H. By Type of *Service* Rendered:
   1. Full service
   2. Limited service (cash-and-carry)
   3. Self-service

I. By *Legal Form of Organization:*
   1. Proprietorship
   2. Partnership
   3. Corporation
   4. Special types

J. By *Management Organization* or Operational Technique:
   1. Undifferentiated
   2. Departmentized

FIG. 4. Outline of selected alternative bases used for classifying retail establishments

tion shown in Figure 4. All of these classes are meaningful for some particular purposes, but it would be an endless and repetitious task to discuss all of them in detail. In this book, attention is confined to a limited number of classification bases which have been selected with care to reveal the more significant characteristics of the retailing structure and to point up the major competitive, social, and economic problems and implications resulting therefrom.

Ownership Classes. Analysis of retail stores in terms of ownership classes has long been of great interest, because this approach involves numerous competitive and other implications. Such a breakdown reveals what groups have an entrepreneurial interest in the performance of retailing functions and which tend to dominate the institutional structure. Certain legislative and tax questions are involved. As is pointed out in the following chapter, state and federal governments have enacted certain legislation which tends to preserve or fortify the status of some ownership classes, while placing handicaps or limitations on others. Stores operated by private organizations come within the purview of our established pattern of income taxation, whereas those operated on a nonprofit basis by consumer cooperative groups or those operated by government units do not. The type of ownership often reflects differences in methods of operation, especially with respect to financial structure, method of procuring merchandise, and the degree to which retail store operations are integrated with the performance of wholesaling and manufacturing functions within the same firm.

Single-Unit Independent Stores. Over a long period of years, the independent retailer who operates a single store has dominated the retailing structure. The importance of this ownership class is indicated by the fact that such stores have comprised 86 to 90 per cent of the total number of retail establishments enumerated in the various Censuses of Business over the quarter of century of coverage from 1929 to 1954. Even though "typical" independent merchants operate smaller stores than their chain competitors, they dominate in total sales volume. Over the same period, the sales of single-unit independents have consistently amounted to about 66 to 70 per cent of the sales of all retail establishments.

With only limited exceptions, single-unit independents are relatively small, family type enterprises that operate solely or almost altogether on the retail level of distribution. In view of the visual prominence of chain retailers, as reflected by their conspicuousness in metropolitan shopping centers and in newspaper and other local advertising media, the persistence of the independent is indeed remarkable. This is a subject which is explored in some considerable detail in the following chapter.

Chains or Multi-unit Retailers. The major competitor of the independent retailer is the chain organization with two or more stores in the same kind

of business. Multi-unit stores have declined from about 14 per cent of the total number of retail establishments in 1929 to about 10 per cent in 1948 and the same per cent in 1954. This decline has been the result of a trend for chain organizations to consolidate their strength through the operation of a smaller number of larger stores. In spite of the decline in number of store units, the sales volume importance of chains has been very stable, amounting to about 30 per cent of total retail establishment sales over the 1929–1954 period. All but a small per cent of multi-unit establishments are owned by chains of *retailers,* as opposed to manufacturers or firms in other ownership classes that operate a number of stores. Thus, the foregoing data are indicative of the relative importance of retailing chains. Because of the great interest in prominent chain retailers and because of competitive adaptations they have forced into the independent retailer's sphere of activity, this ownership class is analyzed in detail in Chapter 10.

Manufacturer-Owned Stores. In certain lines of trade, independent and chain retailers must compete with manufacturers who have integrated their operations forward in the channel of distribution by the use of their own retail outlets.

Several reasons account for this development. First, some manufacturers have opened stores in the belief that complete control over the entire marketing channel constitutes their most profitable alternative. This motive accounts for the presence of various well-known, manufacturer-owned chains in the men's clothing, shoe, candy, and millinery lines of trade. Second, some manufacturer-owned stores are used to supplement other forms of distribution. Three of the best-known tire manufacturers operate company-owned retail outlets, but in no case do these constitute the company's sole outlets for tires and related automotive and household products. Such locations are usually established only in communities where there is an expectation of an unusually large volume of profitable sales, or where suitable independent outlets are not available. Third, a limited number of manufacturer-owned stores serve as experimental stations for testing product innovations or for developing merchandising methods or techniques that may be adapted for use by regular retailers. Finally, some manufacturers utilize their own retail establishments at factory locations in order to dispose of off-selected, rejected, or "stale" merchandise that is not salable through regular channels.

The expansion of retailing activities by manufacturers is limited by two major principles. First, manufacturer-owned stores are feasible only for well-financed companies that produce a relatively full line of related products, or products which are of relatively high unit value. In the absence of this condition, adequate sales volume cannot be obtained in a single retail establishment. As a corollary of this principle, it has become apparent that

successful manufacturer-owned stores usually function as merchant middlemen to some extent. Leading stores owned by men's clothing and tire manufacturers sell many items which are not manufactured by the owner, but which are purchased from outside sources. Such goods are bought to round out the merchandise line, thus increasing sales volume per establishment and enhancing the efficiency with which the retailing organization can be operated.

Second, many manufacturers who might prefer to develop some retail outlets are restrained from doing so by the attitude of independent wholesalers and retailers, who object to such ventures as introducing unfair methods of competition. On certain occasions, the animosity of retailers has been so vociferous that attempts have been made to introduce in Congress legislation to prohibit the operation of retail stores by manufacturers. Integration in marketing channels is now more widely accepted, so that public restrictions of this kind appear highly improbable. The fear of incurring the "ill will" of regular outlets remains sufficiently strong, however, that it deters many manufacturers from engaging in retailing activities.

The importance of retailing by manufacturers is not known exactly. It is probable, however, that the total of manufacturers' sales distributed through their owned retail stores does not exceed 2 per cent of the total of all manufacturers' sales distributed through all channels.[4] To the extent that manufacturers supplement the goods in their stores by purchases from other sources of supply, their retailing activities differ little from those of other multi-unit retailers, except with respect to the major merchandise line handled.

Farmer-Owned Stores. Another ownership class consists of farmers, some of whom maintain roadside establishments or leased facilities in public retail markets. The character of such establishments often results in a misleading impression that they involve, principally or entirely, direct farmer-to-consumer marketing. It is practically impossible for farmers to operate a *regular* retail establishment *on a continuing basis* solely by the sale of their own produce. When an investment is made in physical facilities or when market space is leased, it is almost always necessary for the farmer to buy many items from other farmers and from regular wholesale sources of supply. Consequently, most so-called "farmer establishments" are operated largely in the manner of merchant middlemen.

Experience has revealed that the typical farmer cannot afford to devote time and energy to retailing and expect the same returns that are afforded

[4] Data on the distribution of manufacturers' sales were last compiled for the year 1939 in which it was reported that 2.1 per cent of manufacturers' sales was distributed through manufacturer-owned retail stores. Census of Business, Vol. V, *Distribution of Manufacturers' Sales, 1939* (Washington, D.C.: Government Printing Office, 1942), pp. 6–9.

to him by concentrating on agricultural production and marketing his output through regular wholesale trade channels. Genuine direct retailing of farm produce is confined largely to seasonal and sporadic efforts. There is, for example, a considerable volume of roadside marketing during the home canning season for fresh farm produce. There is also evidence that farmers are most likely to resort to retailing as a desperation measure when prices are low or declining rapidly. For example, direct roadside retailing of Florida citrus fruit was very common in 1947 and 1948 when the reported production cost was 55 cents per crate and the wholesale selling price was only 38 cents. Few growers attempted to engage in direct retailing in 1950 and 1951 when production costs amounted to 58 cents per crate and wholesale prices brought a return of $1.28 per box.[5] So long as wholesale prices are adequate to cover the costs of production and afford the farmer a fair living, he is not likely to engage in the complex of activities necessary for satisfactory retailing.

Government-Owned Stores. In a socialist commonwealth, the government would own and operate all manufacturing and distributive organizations for the benefit of the state. In the United States, however, the organization of practically all of our productive facilities reflects the democratic ideal of private competitive enterprise. Nevertheless, there are highly exceptional circumstances in which governmental units engage in retailing. Certain state governments maintain retail liquor stores. While such stores constitute an important source of government income, that cannot be considered as the motivating factor. The state has the alternative of levying excise taxes of any reasonable amount and could probably obtain the same, and often greater, revenue by such taxation on alcoholic beverages distributed through orthodox retail channels. State operation must then be viewed primarily as a device to effect total social control of the distribution of alcoholic beverages.

Another form of government stores consists of commissaries, post exchanges, and similar establishments often used in connection with military installations, for the purpose of providing a special type of "fringe benefit" to employees on military bases. It is estimated that all classes of government operated stores account for only about one per cent of total retail sales volume.

Consumers' Cooperatives. A consumers' cooperative is a marketing organization owned and operated for the mutual benefit of the ultimate-consumer owners, who have voluntarily associated themselves for the purpose. Such an organization is an attempt to substitute joint or cooperative efforts of consumers for those of private enterprise. Obviously, the needs of

[5] *Marketing: The Yearbook of Agriculture* (Washington: Government Printing Office, 1954), p. 23.

consumers are for goods and services used for personal and household consumption. Properly speaking, therefore, consumer cooperation does not embrace cooperative dealings in industrial or business goods, such as farm supplies or equipment. There are, however, many farm cooperative associations that also handle consumer goods, and thus serve the farmers' interests as individual consumers, although such organizations are primarily concerned with the advancement of the interest of farmers as owners and operators of profit-making agricultural enterprises.

The modern consumer cooperative movement dates from 1844 when a group of poverty-stricken English weavers opened a crude store in the community of Rochdale. Out of the experience of this group, a set of basic principles was developed and these have governed most consumer cooperative organizations whenever they are to be found throughout the world. These so-called "Rochdale principles" highlight the character of consumer cooperation and distinguish it from retailing as carried on by private business organizations. In brief, they are as follows: (1) *membership is open to all* adult persons, without regard to political or religious affiliations or social status; (2) *democratic control* is achieved by providing *all* members with *one* vote, regardless of the amount of stock owned or capital contributed; (3) *limited interest is paid* on capital investment in accordance with the view that capital is to be regarded as the servant, not the master, of the organization; (4) *sales are made at prevailing market prices* for the purpose of accumulating a surplus to be distributed in lump sums to patrons; (5) services are limited, as exemplified by the policy of *selling only for cash;* (6) any surplus accruing from the spread between prevailing market prices and cost of merchandise and store operation is paid to members in proportion to their patronage, and such distributions of earnings are known as *patronage dividends;* (7) consumers' cooperatives are supposed to adhere to a policy of strict *religious and political neutrality;* and (8) certain percentages of earnings are usually set aside for purposes of *education and propaganda* so that the alleged benefits and ideals of consumer cooperation can be spread among nonmembers, thus expanding the scope of operations and extent of influence. While such principles have been widely observed, some cooperative organizations have found it expedient to depart from them. For example, some have tried to attract a wider membership by selling at unusually low prices, and others have refrained from political neutrality by working actively for political candidates who favor consumer cooperation and by stimulating legislation favorable to the cooperative program.

In certain European countries, consumer cooperation has achieved very notable success, especially in England, Scotland, Wales, Sweden, Norway, Finland, Denmark, Switzerland, and Holland. By way of contrast, in the United States *strictly consumer* cooperative establishments (i.e., excluding the operations of those primarily engaged in selling feed, farm supplies, and

petroleum products for farm business use) numbered only 2,330 in 1929, 1,478 in 1948, and 2,227 in 1954. The total sales volume of such establishments in each of these years varied somewhat, but throughout the recent period it has represented only about two-tenths of one per cent of total retail sales volume.

In the light of more than a century of experience with consumer cooperation, and in view of the idealistic character of its objectives, some explanation must be offered for the negligible part of this ownership group in the United States. For one thing, cooperatives in Europe achieved notable success in a competitive environment characterized by small, inefficient, tradition-bound, retail shops. In the United States, their success has been much more limited because consumers have had the opportunity to patronize chains and other limited-service retailers who have succeeded in attaining all types of economies sought by cooperatives. Second, in most European countries, the population has been very homogeneous in terms of heritage, social status, and religious affiliations, all of which has been conducive to cooperative effort. In our country, the population of urban areas is usually heterogeneous, reflecting a variety of occupations, social interests, and cultural values. This has made it unusually difficult to assemble large groups of people who are favorably inclined to the cooperative movement. Third, economic conditions for the masses in the United States have been more satisfactory than in other lands. The American consumer has had a higher level of real income, has felt much less need to "pinch pennies," and has preferred to shop in a wide variety of independent business establishments which afford him an exceedingly wide range of choice of novel and unusual merchandise as well as basic necessities of living. When due consideration is given to the efficiency of our mass distribution retailing organizations, and attention is focused on other circumstances that have limited cooperative development to this time, it appears certain that consumer cooperatives will not become a significant competitive factor in the retail trade structure in America.

Extent and Nature of the Line of Goods Handled. A classification of retail stores on the basis of the extent and nature of the line of goods handled is useful because size, location, and, to a degree, merchandising methods are greatly affected by the type of goods handled. On this basis, three broad classifications of stores are discernible: (1) general merchandise stores, (2) single-line stores, and (3) specialty stores. In distinguishing stores on this basis, the terms "variety" and "assortment" may be employed to advantage. As used in the field of retail merchandising, *variety* implies generically different kinds of goods. Variety may be present in a related line of merchandise such as foods and is indicated by such diverse products as bread, potato chips, canned tomatoes, frozen peas, catsup, cheese, grapefruit,

and so on. It may also exist without any natural association of the items with respect to physical characteristics, purpose for which used, appearance, or established buying habits. Thus, in the *variety* store are found candy, toilet articles, notions, stationery, greeting cards, novelties, toys, hardware, apparel, and so on. *Assortment,* on the other hand, relates to the range of choice once a consumer's demand for a type of article has been defined. A millinery store or department may be said to have broad or extensive assortments if a woman can choose from many styles, colors, materials, qualities, and prices of hats.

General Merchandise Stores. General merchandise stores are those that handle such an extensive variety of goods that they cannot be classified into some kind of business grouping designated by the name of a principal type of commodity sold. Stores within this broad group are of several distinct types, including general stores, department stores, drygoods stores, and variety stores.

General stores are found chiefly in areas of scattered and isolated population, often as the only retail outlet in a small town or at some rural location. Such stores are usually small and nondepartmentized. Among the principal commodities commonly sold are groceries, hardware. dry goods, notions, toilet goods, staple lines of apparel and furnishings. A gasoline pump and very limited automobile service facilities are often a part of such businesses. The general store was at one time of very strategic importance. In 1929 more than 100,000 establishments were so classified and they accounted for more than 5 per cent of total retail sales volume. Because of population growth, many small communities have become large enough to support a number of business establishments, resulting in more specialization by merchandise lines and a change in the operation of many former general stores to greater emphasis upon groceries. Improvements in highways and increased use of motor transportation have made large market centers more accessible to rural area residents. As a result of such developments, the number of general stores declined to 17,701 in 1954 and their sales volume dropped to only 0.6 per cent of total retail store sales.

Department stores are usually large urban retail institutions that handle a wide variety of lines such as women's ready-to-wear and accessories, men's and boys' clothing, piece goods, small wares, and home furnishings. Such merchandise is segregated into separate departments for purposes of promotion, service, accounting, and control. Because department stores normally serve a large trading area, they are usually located in downtown areas. Many, however, are to be found in secondary shopping districts of large cities. Some of these are branches of downtown department stores. The distinguishing feature of department stores is *variety* of shopping goods offerings, organized departmentally. When the department store is operated

on a sufficiently large scale, individual departments are as large as or larger than ordinary specialty stores and are characterized by breadth of assortment as well as variety.

Drygoods stores are very similar to department stores in terms of merchandise handled, although home furnishings are often absent from their offerings. They are classified separately, as shown in Table 11, because they do not meet certain department store classification criteria, including the sale of required merchandise lines, large scale operation, or departmental organization.

As the name implies, *variety stores* handle many different kinds of merchandise of low unit value. They were the first important type of institution to emphasize self-service methods of retailing. Operations are characterized by giving merchandise maximum open display, rather than by providing active personal selling assistance by salespeople. The role of the salesperson is that of maintaining the stock in order and handling the transaction for the consumer. These stores are still popularly known by their historical connotation, namely, as "5 and 10 cent stores." This term is no longer descriptive, because price lines have been greatly extended as such stores have given more and more emphasis to shopping goods. Originally, they were essentially convenience goods stores. They are found in both downtown and outlying shopping district locations but are generally situated at points of heavy concentrations of consumer traffic, and most of them are units of chain organizations. They are, furthermore, mostly limited-service stores, as neither credit or delivery is offered except under terms where a specific charge is made for the service and, as already indicated, only a minimum of personal selling assistance is provided to the consumer.

As shown in Table 11, stores in the general merchandise group have tended to decline in sales volume importance. This is explained in part by the decline of the general store and in part by increased consumer expenditures for automobiles and other items not commonly sold by general merchandise group stores. With the exception of the general store, the other types within the general merchandise group have occupied a stable competitive position in comparison with other retail establishments that sell comparable merchandise.

Single-Line Stores. An extensive variety of one line of merchandise that is *related in sale or use* is the basis for classification as a single-line store. Such stores are usually designated in terms of the principal line of merchandise handled, such as groceries, drugs, hardware, men's clothing, furniture, or jewelry. In a men's clothing store, for example, a consumer expects to find all kinds of men's apparel including hosiery, shoes, underwear, shirts, neckwear, suits, coats, and hats. Large assortments of any one of these kinds of merchandise are found only in fairly large clothing stores. Thus it may

be said that the basis for the single-line store is related variety; large assortments within this classification are dependent upon a scale of operation that permits the merchants to carry an extensive inventory of merchandise.

When single-line stores operate on a very large scale, they are usually departmentized. This is especially true in the supermarket and chain drugstore fields, as well as in the furniture and apparel trades. Stores handling men's, women's, or family apparel and organized on a departmental basis are commonly known as "departmentized specialty stores." This gives rise to some confusion because the word "specialty" in this case is used to distinguish such stores from regular department stores rather than to denote the type of limited variety characterizing small specialty stores which are described in the following section.

Historically, single-line stores tended to replace general stores as small communities grew in size. While their variety of merchandise is ordinarily much more limited than in stores of the general merchandise group, it is much more extensive than in the case of specialty stores. Thus, the single-line store is usually somewhat larger than the ordinary specialty store. It is, furthermore, somewhat more complex in the sense that a large number of merchandise items must be assembled and displayed.

Specialty Stores. This term is used to refer to stores which handle an extremely limited variety of goods. In some trades, practically all establishments are of this highly specialized character. Examples include automobile dealers, gasoline service stations, florists, and book stores. In other instances the specialty store handles only part of a line of goods customarily sold by single-line stores. Single-line grocery stores compete with specialty stores such as baked-goods establishments, dairy stores, and meat markets. In the clothing field, single-line stores divide the market with specialty stores such as shoe stores, millinery shops, hosiery stores, corset and lingerie establishments, maternity dress shops, and furriers. Because specialty stores confine their merchandising efforts to a narrow range of merchandise items, they are able to offer much more extensive assortments than single-line stores of comparable sales volume size. A men's shoe store, for example, is a highly specialized operation, in which the consumer expects to find a wide range of styles, colors, qualities, and prices in the size that he is accustomed to wearing. The operation of a specialty store should not be confused with the sale of specialty goods. The term "specialty" when used to designate a type of store implies specialization in a limited variety of goods. These may be convenience goods as illustrated by cigar stands in hotels and office buildings, they may be shopping goods such as the lines of apparel used in the foregoing examples, or they may be specialty goods such as automobiles, vacuum cleaners, or collectors' items as, for example, rare postage stamps.

TABLE 11

Number of Retail Establishments and Per Cent of Total Retail Establishment Sales, by Kind of Business—United States: 1939, 1948, and 1954

Total Sales: 1939, $41,444,507,000; 1948, $128,849,252,000; 1954, $169,967,748,000

Kind of Business	Number of Establishments			Per Cent of Total Sales		
	1939	1948	1954	1939	1948	1954
United States, total	1,760,903	1,668,479	1,721,650	100.0%	100.0%	100.0%
Food group	551,097	460,913	384,616	23.0	22.7	23.4
Grocery stores	387,337	350,754	279,440	18.7	19.2	20.3
Meat, seafood markets	42,360	23,920	22,896	1.8	1.4	1.3
Candy, nut, confectionery stores	48,015	27,165	20,507	0.7	0.5	0.3
Bakery product stores	16,985	19.500	19,034	0.4	0.6	0.5
All other food stores	56,400	39,574	42,739[b]	1.4	1.0	1.0
Eating and drinking places	305,386	325,789	319,657	8.5	8.3	7.7
General merchandise group[a]	89,955[a]	70,807	76,198	15.7	12.3	10.5
Department stores[a]	4,074[a]	2,558	2,761	9.6	7.3	6.2
Dry goods, general merchandise stores	29,247	28,744	34,113	1.7	2.1	1.9
General stores	39,688	20,588	17,701	2.0	0.9	0.6
Variety stores	16,946	18,917	20,917	2.4	1.9	1.8
Apparel group	106,959	110,944	119,743	7.9	7.5	6.5
Men's, boys', wear stores	21,501	17,857	19,247	1.9	1.6	1.4
Women's apparel, accessory stores	43,113	41,999	45,213	2.9	2.9	2.5
Family clothing stores	10,053	9,931	11,056	1.0	1.4	1.0
Shoe stores	20,487	19,201	23,847	1.5	1.1	1.1
All other apparel stores	11,805	21,956	20,380	0.6	0.5	0.5
Furniture, home furnishings, appliance group	52,827	80,423	91,797	4.2	5.4	5.1
Furniture stores	19,902	28,465	25,475	2.3	2.6	2.5
Appliance, radio, TV stores	20,913	35,331	40,542	1.3	1.9	1.9
All other home furnishings stores	12,012	16,627	25,780[b]	0.6	0.9	0.7
Automotive group	60,132	85,285	85,953	13.4	15.6	17.6
Motor vehicle dealers	40,589	60,594	61,547	12.0	14.3	16.2
Tire, battery, accessory dealers	18,525	20,224	18,845	1.3	1.0	1.0
Motorcycle, aircraft, boat dealers	1,018	2,350	3,183	0.1	0.1	0.1
Other automotive group dealers	n.a.	2,117	2,378[b]	n.a.	0.2	0.3
Gasoline service stations	241,858	179,647	181,747	6.8	5.0	6.3
Lumber, building, hardware group	79,313	97,342	100,519	6.6	8.6	7.7
Lumber, building material dealers	25,067	25,978	30,177	3.6	4.0	3.8
Hardware stores	29,147	34,009	34,858	1.5	1.9	1.6
Paint, glass, wallpaper stores	8,480	9,403	9,249	0.4	0.4	0.4
Farm equipment dealers	10,499	17,509	18,689	0.9	1.9	1.7
Plumbing, heating, and other building group dealers	6,120	10,443	7,546[b]	0.2	0.4	0.2
Drug and proprietary stores	57,903	55,282	56,009	3.1	3.1	3.1
Other retail stores	215,473	197,130	226,903	10.8	9.7	9.4
Liquor stores	19,136	32,949	31,240	1.4	2.0	1.9
Fuel, ice dealers	41,172	21,473	27,070	2 4	2.0	1.9
Feed, farm, garden supply stores	21,687	21,149	23,792	1.9	2.5	2.4
Jewelry stores	14,559	20,550	24,266	0.9	0.9	0.8
Book, stationery stores	7,881	6,211	8,115	0.5	0.3	0.3
Sporting goods stores	3,546	6,422	8,396	0.2	0.2	0.2
Florists	16,055	13,365	16,279	0.4	0.3	0.3
Cigar stores, stands	18,504	12,791	6,068	0.5	0.3	0.2
Music stores	2,930	5,700	5,810	0.2	0.3	0.2
Second-hand stores	23,962	13,387	14,364	0.3	0.2	0.2
All other retail stores	46,041	43,133	61,503[b]	2.1	0.7	1.0
Nonstore retail establishments[c]	n.a.[b]	4,917[b]	78,508	n.a.	1.8	2.7

See following page for footnotes.

Specialty stores often have relatively simple buying problems in that most or all of their merchandise is drawn from a single source of supply or from a very limited number of suppliers in the same specific industry. They have a competitive advantage over single-line stores in terms of assortments carried, but have a handicap in the more limited opportunity for related item selling. Specialty stores, for the most part, operate in well-established shopping districts where there is a continual flow of consumer traffic.

Kind of Business Groupings. Single-line and specialty stores are not separately classified in Census tabulations, and it would probably be impossible to effect a classification system that would provide quantitative information about each of these two classes. For purposes of business use it is more desirable to classify both single-line and specialty stores within kind-of-business classifications, as shown in Table 11. With the exception of the general merchandise group, all stores included in this table may be considered as single line or specialty. It is easy to distinguish certain single-line operations, such as grocery stores, from specialty establishments such as meat markets or candy stores. In other cases, such distinctions are not possible. One women's dress shop may handle a large variety of apparel, and be classified as a women's clothing store; another may specialize to the extent of selling only cotton dresses within a narrow price range, but still be grouped in the same classification.

Trends in Lines of Goods Carried.[6] In the late 1940's and early 1950's two different and apparently contradictory trends were observable with respect to the extent of the line of merchandise carried by retail stores. On the one hand, there is a tendency toward greater variety in many urban stores, especially in newer shopping centers. Grocery stores of the supermarket type have become strongly entrenched in merchandising certain non-food lines including drugs, toilet goods, paper products, books and magazines, and many items of housewares. Variety stores have expanded their price ranges and have increased their relative emphasis upon apparel and

n.a. = not available

[a] Data for 1939 not comparable with figures for later years. Tabulations for 1939 include general merchandise mail order establishments which are classified as department stores but which are included as nonstore retail establishments in 1948 and 1954. In 1939, a store was not classified as a department store unless it had sales in excess of $100,000. In 1948, this requirement was changed to a minimum of 25 regular employees, with the effect of excluding many smaller stores of the department store type from the department store classification.

[b] Includes some small stores without payroll which belong in other classifications within this group but which could not be more specifically classified on the basis of data provided on census schedules.

[c] This group includes mail order establishments, offices of house-to-house selling companies, and establishments of vending machine operators. In 1939, and probably to some extent in 1948, such establishments were classified in other kind of business groups, on the basis of the type of commodities sold.

Source: U. S. Census of Business for the respective years. See note (1) to Table 8.

[6] This discussion is adapted, in part, from William R. Davidson, "Retailing—Some Significant Current Developments," *The Appraisal Journal,* January, 1957, p. 94.

other soft goods merchandising. New units of many drug chains have become larger and more diversified in terms of merchandise offerings. Many modern hardware stores carry a much more extensive line of goods than that historically associated with this line of trade. Pressure to increase variety has come from the desire to add items with a larger gross profit margin and to increase sales volume per store, thus reducing certain overhead expenses. This trend has progressed to the point where various types of stores have assumed more and more of a semi-general-merchandise character, with the result that it is often difficult for a consumer to tell just what kind of a store he has entered, whether it is a drugstore, supermarket, variety store, or a unit of a general merchandise chain.

On the other hand, there appears to be a movement toward a higher degree of specialization in many stores. While not sufficiently pronounced to be reflected in the 1954 Census of Business tabulations for the whole country, there appears to be more emphasis in urban shopping centers on specialty food stores such as baked-goods establishments, fresh poultry stores, gourmet shops, and kosher-type delicatessens. While some drug chains have opened larger and more diversified establishments, many independents have reverted to the older concept of specialized ethical drugstores, without fountains and miscellaneous merchandise departments. Many new shopping centers include a large number of very highly specialized stores like drapery fabric stores, sewing machine stores, hobby shops, toy stores, children's shoe stores, phonograph record stores, greeting card shops, and floor covering establishments.

These two trends indicate difficulties for many ordinary single-line stores such as the usual older type of grocery, clothing, drug, or hardware store. Especially in major cities, there are many single-line stores that have no particular advantage with which to attract patronage. In small towns or in neighborhood locations in cities, where there is a distinct advantage of convenience of location, single-line stores will undoubtedly continue to function satisfactorily. In other cases, they are experiencing increasing difficulty in competing with establishments which can *either* serve a greater variety of consumer wants because of the expanded line of goods carried *or* can do an extremely effective merchandising job because of their narrow specialization in only part of an ordinary line of merchandise.

Classification by Location. Classification of stores according to location indicates the extent to which the retail trade structure is concentrated or dispersed, and it reveals something of the character of consumer buying habits. Stores are found (1) in rural buying centers; (2) in small cities or towns, in their downtown areas or in neighborhood locations; and (3) in urban areas in a wide variety of specific types of locations, including central business districts, secondary business districts, string street locations, neigh-

borhood sites, planned or controlled shopping centers, and leased stalls in retail public markets.

Although much has been written about the huge volume of retail trade conducted in the central business districts of large cities, retailing is nevertheless largely a local business. As shown in Table 12, the distribution of

TABLE 12

NUMBER AND SALES VOLUME OF RETAIL ESTABLISHMENTS IN 1954 AND POPULATION BY STANDARD METROPOLITAN AREAS AND REMAINDER OF COUNTRY—UNITED STATES (Percentage Distribution)

Area	Number of Establish-ments	Sales Volume	Popula-tion
14 largest metropolitan areas with population of more than 1,000,000 each[1]	28.9	34.0	29.5
158 metropolitan areas with population of less than 1,000,000 each	26.6	30.7	27.0
Remainder of country	44.5	35.3	43.5
Total[2]	100.0	100.0	100.0

1 Includes Baltimore, Md.; Boston, Mass.; Buffalo, N.Y.; Chicago, Ill.; Cleveland, O.; Detroit, Mich.; Los Angeles, Calif.; Minneapolis-St. Paul, Minn.; New York-Northeastern N.J.; Philadelphia, Penn.; Pittsburgh, Penn.; St. Louis, Mo.; San Francisco-Oakland, Calif.; and Washington, D. C.
2 Totals for retail trade are as follows: establishments, 1,721,650; sales volume, $169,967,748,000.
Source: U. S. Census of Business, Retail Trade.

retail stores among the largest metropolitan areas,[7] other metropolitan areas, and the remainder of the country (small cities and rural areas) corresponds almost exactly with the distribution of population among these areas. Large- and medium-sized cities account for a somewhat larger proportion of sales volume than expected on the basis of their populations, because they draw some trade from smaller cities and rural buying centers surrounding them. This is particularly true of large department stores, other large shopping goods establishments, and specialty goods stores that handle merchandise not ordinarily found in small towns, at least in broad and attractive assortments. Still, 44.5 per cent of the stores are found outside the structure of metropolitan areas. That the 43.5 per cent of the people who reside in such

7 A standard metropolitan area is a geographic unit which includes at least one central city of 50,000 or greater population and the county or counties that are socially and economically integrated with it. The boundaries of metropolitan areas may cross state lines. They often include more than one major city, especially when such cities are within 20 miles of each other. While most metropolitan areas consist of a single county, many contain two or more counties, provided the counties outside the central-city-county are socially and economically integrated with the central county to a high degree. Generally speaking, a metropolitan area is considerably smaller than the market area or retail trading area served by the central city. For a complete discussion of the criteria used in delineating metropolitan areas, see *County and City Data Book 1952—A Statistical Abstract Supplement* (Washington, D. C.: Government Printing Office, 1953), p. xi.

areas buy most of their goods locally is attested by the fact that over 35 per cent of the total volume of retail store sales is done by stores located outside of metropolitan areas.

Other Classifications. The foregoing discussion of classifications of retail stores has revealed many of the varied characteristics of our retailing structure. It has not been sufficiently detailed, however, to present all *institutional developments which are of interest to the student of marketing.* Consequently, additional significant classifications are introduced in subsequent chapters in connection with analyses of small and large-scale retailers, department stores, chain stores and voluntary chains of independent retailers, supermarkets, planned shopping centers, discount houses, mail order companies, house-to-house selling organizations, and vending machine operations.

Adaptive Behavior within the Retailing Structure. It is appropriate to conclude this introductory chapter on retailing with an examination of the extent to which the behavior of retailing institutions reflects flexibility and the willingness and ability to adapt to a dynamic environment. This may be done by means of a brief historical review of institutional evolution.

Pioneers in the development of this country traded furs for manufactured goods at trading posts. Later the Yankee peddler brought cutlery and tinware from New England and other producing centers to the Ohio Valley and even on to the West as settlers demanded goods which they themselves could not produce. But as population increased, the need for the trading post and the peddler disappeared, since the general store could take their place and render a more complete service. It performed many marketing functions which the more simple institutions could not render and which became necessary as the population became larger and as the standard of living became somewhat higher.

With further increases in the size of cities and an enhanced flow of manufactured goods, single-line stores came into being and began to dominate the retail trade structure. Specialization in merchandise continued in the largest market centers, with the advent of specialty stores. Many single-line and specialty stores that had established a reputation by about the time of the 1860's added other merchandise lines, thus enlarging the scale of their business by the operation of a number of separate shops under the same ownership in the same establishment. In this manner department stores were born, but this was not possible until urban areas had grown in size to permit the functioning of rather large establishments and until developments in urban transportation made it relatively convenient for consumers to visit downtown areas with some frequency. Almost paralleling the development of the department store was the mail order house which was evolved to bring large selections of merchandise to consumers

in sparsely populated areas that could not support the operations of a variety of retailing establishments. Spectacular growth in mail order sales took place after 1913, with the inauguration of rural free delivery service and parcel post.

As factory production increased, a number of astute and far-seeing merchants conceived the idea of applying standard operating procedures to multi-unit organizations. The Great Atlantic & Pacific Tea Company was founded in 1858 and the F. W. Woolworth Company in 1880. A number of other leading chains were also formed in the nineteenth century, but their period of greatest expansion came with increasing urbanization which proceeded at a fast pace during the 1920's. Through the consolidation of buying strength in a large central organization and by standardized procedures for limited-service retailing, such organizations won public favor by satisfying price-conscious consumers whose wants had apparently grown faster than their purchasing power.

Corporate chain developments of the 1920's had an adverse effect upon independents and their wholesaler suppliers. These groups adapted their operations to changing conditions, partly through the defensive mechanism of the voluntary chain which was conceived to bring similar kinds of purchasing and operating economies to the independent's sphere of activity. The supermarket, a development of the 1930's, reflects the growing importance of the automobile and the lessening need for grocery establishments in locations which are conveniently accessible to all consumers. It reflects also the more general recognition of the fact that consumers are willing to assume responsibility for the performance of some part of the marketing functions, provided that self-service activities are accompanied by price advantages and an attractive atmosphere for shopping.

In more recent years, changes in retailing institutions have taken a variety of forms. The branch store of the large city department store has arisen in response to the movement of population to the suburbs and to communities surrounding the cities. The modern type of completely planned or "controlled" drive-in shopping centers reflects also the impact of the decentralization of urban population. Furthermore, the operations of shopping centers of this type are explained by the increased use of the automobile and downtown traffic congestion and parking problems associated therewith.

In the early 1950's, traditional concepts regarding the gross margin of profit necessary to cover the normal costs of merchandising appliances and other high unit value merchandise were shattered by successful "discount houses." Such stores offered nationally advertised merchandise under conditions of limited store service at substantial discounts from prevailing prices in regular outlets. Their success may be attributed to their ability to make a large volume of sales at a relatively low gross profit per unit,

and cover all necessary costs from the large volume obtainable in a modern mass market dominated by middle-income classes of consumers with unparalleled levels of purchasing power. The growth of such organizations forced department stores and other retailers to re-evaluate their performance, and to bring about changes in operating methods and promotional strategy so that they could compete effectively.

Although the development of retail institutions in this country followed the pattern just indicated, many remnants of earlier types still remain. The peddler still visits remote areas, and in the congested sections of many cities he still appears as the pushcart man. The general store, while declining in importance, still serves in thousands of villages, as it has for many years past. All of this illustrates the basic marketing principle that *if an institution performs essential functions, it continues to exist so long as the conditions which favored its development remain in some degree.* The responsiveness of retailing institutions to an ever-changing social and economic environment indicates the existence of a corollary, namely, that *when the need for a new type of institution is apparent, it will tend to be evolved.*

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:

   a) retailing
   b) retail sale
   c) retail establishment
   d) retail store
   e) consumers' cooperative
   f) general store
   g) general merchandise stores
   h) department store
   i) departmentized specialty store
   j) single-line store
   k) specialty store
   l) nonstore retailer
   m) variety
   n) assortment

2. Are all retail sales made by retail establishments? Are all sales of retail establishments retail sales? Explain.
3. Do retailers engage in production? Are they concerned with form utility production? Explain.
4. In 1929, the total sales volume of retail establishments amounted to about $48 billions. By 1954, the volume had increased to about $170 billions. How can this increase be explained?
5. What has been the trend in the total number of retail establishments in operation over the period 1929 to 1954? How is this related to the scale of operations in retailing? Explain.
6. A large manufacturer of men's clothing sells direct to the consumer through a chain of its own stores. In its advertising, it features the appeal, "Buy direct from the manufacturer and save the middleman's costs and profit." The stores in this chain are large and are organized into different departments including coats, suits, sportswear, and furnishings such as shirts, ties, underwear, hosiery, gloves and scarfs, and men's jewelry and gift items. Evaluate critically the advertising appeal of this organization.

7. Outline the basic principles of consumer cooperation. Which of these principles are especially significant with respect to distinguishing consumer cooperative establishments from establishments operated by regular retailers?
8. How important are consumers' cooperatives in the United States retailing structure? How can you account for this situation?
9. Compare the quantitative importance of independent retailers with the position of retail chain organizations. To what extent are manufacturers and farmers actively engaged in retailing?
10. What types of realignments have occurred within the retailing structure in terms of the extent and nature of the line of goods carried by stores? What are the competitive implications of such trends?
11. In the Census of Business for 1929, more than 100,000 general stores were enumerated, but by 1954 the number of such stores was less than 18,000. Does this indicate that some 80,000 such stores failed in business over this period? Explain.
12. Under what conditions and to what extent are government establishments engaged in retailing in the United States?
13. How does the geographic distribution of retail establishments and retail store sales volume compare with the distribution of population?
14. What are the various bases for classifying retail establishments? Is there one best basis? Explain.
15. Outline the types of detailed information concerning retail establishments which are now available in the Census of Business. Examine the most recent census material in obtaining this information.
16. What important types of retailing institutions have appeared and developed in the United States during the past three-quarters of a century? What factors do you consider most influential in the appearance of each type? Explain.
17. How does this chapter compare to a chapter on anatomy in a medical book?
18. Examine the various components included in the Bureau of Labor Statistics' Cost of Living Index. (This information may be obtained from a recent issue of the *Federal Reserve Bulletin*, the *Survey of Current Business*, or the *Monthly Labor Review.*) Would this index be suitable for purposes of adjusting dollar retail sales figures to a basis of comparable values? Why, or why not? Is there any reason to believe that the cost of living was affected differently than retail prices in the inflationary period following World War II? Explain.
19. "Newer types of retail institutions developed because existing institutions were no longer fulfilling the needs of the American communities. They must have enjoyed an economic advantage in order to have gained a foothold. Yet, the older institutions still exist and even flourish in certain instances. If there were adequate competition, these retailers would have been driven out of existence. In other words, if chains, supermarkets, etc., are better, how can such retailers as general stores hang on? If they are not better, why did they come into being?" Criticize and analyze fully.

8

SMALL-SCALE VERSUS LARGE-SCALE RETAILING

Within the retailing structure, different classes and types of institutions are engaged in an intense rivalry for consumer patronage. An interesting and significant aspect of this competitive struggle is the fact that small-scale retailers have dominated it continuously. As pointed out in the preceding chapter, smaller independent stores are not only the most numerous type of establishment, but they also account for the great bulk of total retail sales volume. As a class of institutions, smaller retailers must compete with a wide variety of organizations that operate on a considerable scale. These latter include all types of multi-unit or chain organizations as well as large individual establishments of the department store, departmentized specialty store, supermarket, and mail order types. In this chapter, attention is devoted to the common characteristics, the general competitive situation, and the outlook for small-scale versus large-scale retailing.

Small-Scale Retailers

Precisely what constitutes small-scale and what comprises large-scale retailing operation has been vigorously debated in many quarters and with little resulting agreement as to the criteria that should be employed in making such a distinction. A precise dividing line is, however, of very dubious significance for the purpose of studying retail institutions. This is true because it is easy to set forth certain facts that demonstrate conclusively that the most prevalent form of retail enterprise is the type of independently owned store that would be judged as small by anyone's standards.

It is particularly significant that about 70 per cent of the stores in the nation are of the single proprietorship form of organization, averaging

about 3 workers per establishment, including active proprietors, unpaid family workers, and part-time and full-time paid employees. While there are some proprietorships with many more employees than this, most of them are operated only by the proprietor with some family assistance or with not more than one paid employee outside the family.

From the standpoint of sales volume, over 60 per cent of the stores had annual sales of less than $50,000 in 1954, or less than about $160 per operating day. In fact, the number with sales of less than $20,000, or about $65 per operating day, amounted to about 30 per cent of the total. On the other hand, only 3 per cent had annual sales in excess of $500,000.

Common Characteristics. One important fact about smaller independent stores is that *they are found wherever retail transactions take place.* Locations vary from the rural crossroads to the heart of the city. Merchandise sold by them ranges from the exclusive gown or plumbing fixture to peanuts, fruit, or notions. Regularly operated roadside stands are smaller stores just as are cigar and newstands in the lobby of an office building and as is the diamond merchant whose place of business is high up in an office building.

A second characteristic is that of *nonspecialized management.* The owner or manager is responsible for all managerial functions. Merchandising strategy, pricing policies, accounting technique, personnel matters, and all other managerial functions fall to the one man. Selection of location, determination of the proper fixtures, and merchandise layout must all be solved by the single owner. It is true that wholesalers and manufacturers give some assistance on these matters, but it is significant that the ability to understand such assistance and to make the applications to his store are dependent upon the general level of intelligence of the owner-manager himself.

A corollary of single management is the *absence of specialized employees.* The manager must install window displays and write advertisements, and he must do without the technical assistance of the trained accountant except when one is retained for the preparation of tax returns or for other special purposes. The owner must train the employees, a task which is often neglected or overlooked in stores of this type. The manager may, by virtue of experience, interest, or natural ability, be able to perform some of these functions very efficiently. In fact, his direct interest in the success of his store may even lead him to discharge some of these responsibilities far more efficiently than will the hired manager of a competitive chain unit. Very few such entrepreneurs, however, can carry on *all* these functions as efficiently as can the specialized employees of the larger retail stores.

Another characteristic is a good *opportunity for contacts between the retailer and his customers.* Lack of direct personal incentive on the part of hired managers and frequent change of chain store managers give the inde-

pendent merchant a distinct advantage. Moreover, he is not restricted by organization rules of the chain which, although generally desirable, may be a handicap to the particularly energetic and friendly manager of a chain unit. Since the owner usually spends most of his time on the selling floor, his managerial functions being performed in the main when the store is not open to the public, he has an opportunity to know the wants of his customers as a whole and to become interested and helpful with respect to needs of individual patrons. Special orders, for example, may be placed which would not fit into the routine of a chain. If the merchant's personality is pleasing, it aids him in establishing steady customers for his store. If it is not, the reverse may be true.

In general, smaller independent stores are *service* institutions. Since price appeal is normally not their policy, attention can be given to such matters as the customer's preference as to the thickness of steak, the flavor of ice cream, or the brand of cigar which he prefers. Notification of receipt of a dress which is believed to be of special interest to a certain patron is a policy commonly followed by the smaller dress shops. Personal relations of this type, although sometimes developed also by the larger institutions, are not common to the latter, since such stores must succeed by pleasing a large number of average customers through standardized service. The operator of the smaller independent store can afford to, and often does, individualize his service.

Competitive Advantages and Disadvantages. Smaller independent stores, as a class of retailing institution, enjoy certain competitive advantages that have favored their growth and development and, on the other hand, they are also subject to several general disadvantages which prevent them from attaining a larger proportion of the total volume of retail trade. Some of these favorable and unfavorable factors, which are sufficiently common to be deemed representative, are clearly evident or may be surmised from the foregoing discussion of their common characteristics, whereas others are not so apparent. Knowledge of these considerations is essential in appraising the present importance of such institutions and in prognosticating their likely situation in future years.

Advantages. One important advantage is that throughout the smaller independent store field the *explicit costs of doing business are generally low* in relation to sales. These costs include out-of-pocket outlays and other items, like depreciation, carried on the accounting records as costs. Selling costs are low because the proprietor and other family employees often derive their compensation in the form of net profit rather than in wage or salary payments which must be made from weekly or monthly business income. Often the location of such stores enables them to pay low salaries to hired employees and to utilize rather unskilled part-time help. Rental

costs tend to be low, partly because large numbers of such stores are located in neighborhood or rural areas, also because ownership of store premises by the retailer is much more common among smaller independents than it is among chains or large-scale independent operators.

Second, *in many cases a small independent store is operated by one who devotes only a part of his time to the store.* Were it not for this advantage, it would be impossible for many small retailers to continue in business. Consider the problem of operating a store with about $50,000 annual sales volume. While gross profit margins vary considerably with different lines of trade, about 25 per cent is a figure reasonably representative for a wide range of businesses. This means that about 75 per cent of sales, or $37,500 would be required to cover the cost of merchandise sold, and that only about $12,500 would be available as gross profit, from which all expenses must be paid before there is any residual net profit. If any reasonable allowance is made for store operating expenses such as rent, advertising, store supplies, telephone, heat and light, insurance, depreciation on fixtures and equipment, and, perhaps, some employed assistance, it is readily apparent that such a merchant would have a difficult time in realizing enough personal income to afford a decent standard of living. The problem is greatly simplified in this example because, as has been indicated, many stores have much less than one-half such annual sales volume. Thus, it is possible for many small merchants to operate such businesses only because they may be engaged in some other gainful employment, either as salaried workers or as entrepreneurs in other enterprises, or because they are able to supplement income realized from the store with disability benefits, or annuity or retirement income. When due consideration is given to this point, one must refrain from passing judgment on the economic justification of such stores merely on the basis of their small size.

The advantages thus far mentioned may be thought of by some as uneconomic or even antisocial. Yet the fact remains that a store which can operate only with the help of unpaid members of the family, or one which exists only because the owner has other income, constitutes a definite part of our distribution system, and it does have the advantages mentioned. Moreover, in its limited way it may serve urgent needs of customers who find it convenient or otherwise desirable, while at the same time supporting in part or entirely many persons who might not otherwise be gainfully employed.

Third, and undoubtedly most important, is the advantage of *convenience of location.* Since the great majority of such stores deal primarily in convenience goods, they are located mainly with reference to the homes of customers. Numerous studies of patronage motives have revealed the importance of location as a fundamental reason why consumers buy from independent merchants.

A fourth common advantage is the *opportunity for close personal contact that grows out of the size of smaller independent stores.* The ability to establish and maintain friendly relationships with customers and cater to their personalized tastes, together with the fact that credit granting is more important among independents than among chains, is a strong argument for the well-being of the smaller independent merchant. Unfortunately, opportunity and realization do not always go hand in hand. In numerous individual cases, this advantage shrinks into insignificance because favorable customer relationships, either in connection with a cash or credit operation, are developed only by merchants with considerable energy, initiative, and ability.

Disadvantages. The outstanding unfavorable factor among smaller independents is their *buying handicap.* They cannot enjoy the lower prices which come from large-scale purchases unless they join some form of group-buying organization, and even then they are rarely able to offset entirely this handicap. Wholesalers who must make small and frequent deliveries cannot offer the same low prices which they can give to the larger buyers who have both the storage space and the finances to permit larger purchases and whose scale of operation permits buying in larger quantities without greatly retarding their rate of stock turnover.

Furthermore, the smaller stores *lack* the *specialized skill* so often essential in making wise selections of merchandise for resale. It is difficult for the smaller merchants to follow the intricacies of the fashion cycle as completely as do the buyers in the larger organizations. Smaller independent merchants do not as a class make frequent visits to major wholesale market centers.[1] In fact, the great majority must buy from catalogs or from salesmen who visit the store. Opportunities to select from wide assortments or to secure attractive prices are thus limited.

One result of the lack of specialized employees is that the aid to management given by the *trained accountant is missing.* Guidance data secured from him as to costs and returns are often wholly lacking, yet they constitute, as was so well said many years ago, "the rudder which shows which way the ship goes."[2]

A fourth competitive limitation is the *inability to advertise* on a scale comparable with chain store organizations or large-scale independent stores. Small stores often spend as large or even a greater proportion of their sales volume for advertising as their larger rivals, yet the dollar expenditures are necessarily small. This limits the small merchant's ability to utilize media with large circulation. Even in small cities where such merchants may be able to afford advertising space comparable with chain units, the limited

[1] Furniture dealers and merchants in some other lines do attend shows or exhibitions once or twice a year.

[2] Daniel Defoe, *The Complete English Tradesman,* London, 1725, chap. xxxi.

funds and lack of specialized talent often result in ineffective layouts or poor copy.

Fifth, the small independent is distinctly *limited* with respect to *ability to innovate or experiment.* A chain store can try out a new merchandising technique or idea in one unit, or a department store in one department, and if the results prove unfavorable, the loss may be easily absorbed by profits arising from the operations of other divisions of the business. The small merchant, however, does not have this favorable distribution of risks and usually must follow rather than lead the field with respect to new developments.

Sixth, most smaller stores suffer from their *inability to utilize personnel and capital resources efficiently.* Surveys of operating results conducted by various associations of retailers reveal that the smallest classes of stores almost invariably have lower ratios of "sales per employee" than the medium-sized and larger stores in the same trade classification. For example, in a 1954 survey of hardware stores, it was revealed that stores in cities of under 5,000 population and with sales of less than $25,000 experienced sales of only $11,970 per employee; within the same city-size class, stores with annual volume of $50,000 to $100,000 reported sales of $19,680 per employee and those with annual volume of over $200,000 had sales of $24,765 per employee.[3] Ratios of "sales per square foot of store area" also vary directly with the sales volume size of establishments in most lines of trade, demonstrating that space and other capital resources are utilized more efficiently in larger firms. This disadvantage makes it necessary for small retailers to employ unskilled personnel that can be hired for low wages and to use physical facilities in low-rent locations; these conditions, in turn, are doubtless significant factors that contribute to continuing low levels of operating efficiency in the smallest firms.

Another common though not universal disadvantage of the smaller stores is *lack of managerial ability.* Although it is impossible to measure this alleged lack of ability, it is evident that a large number of independent store owners cannot boast of great business ability. Because of location, friendship, lack of competition from more capable merchants, or other favorable circumstances, these merchants have been able to function effectively enough to stay in business. But this fact does not constitute proof that either the individual involved or that members of his class can continue to withstand the types of competition which are emerging. A question of serious import is whether very small stores can attract efficient owners or pay the going rate for capable managers. In fact, there are reasons to believe that the general level of managerial ability has risen in recent years among independent stores generally, but it is not believed that this applies

[3] *A Manual for Management of Retail Hardware Stores* (Indianapolis: National Retail Hardware Association, 1955), pp. 7, 9, 11.

to the management of the smallest such establishments. If this is true, independent store operation may prove unattractive to young men of outstanding ability and thus add to the difficulties of existing independents in meeting the competition from the larger-scale merchandising institutions.

Failures in Retailing. The operation of a retail store, as in the case of other business enterprises, involves considerable risk. Many stores are closed each year because of the inability of the owner to meet his financial obligations. Even more are closed because the proprietor has not been able to secure the return on his capital and invested time to justify continuation of the enterprise. When a retailer ceases to operate his store, some disturbance of normal retail relationships usually occurs. Often closing-out sales are at price levels which, if met by competitors, result in loss to them. Landlords lose tenants. Supply houses may have to take back fixtures which are no longer new. A failure, rather than voluntary cessation of store operation, involves losses to creditors. But perhaps the greatest loss is that of morale. His experience as an entrepreneur is often so unfortunate as to make it difficult for the failing retailer again to show the initiative and daring which must characterize successful business operations. It is therefore important to note the extent of failures, some of the common causes, and possible remedies.

Numerous studies have been made of failure rates among retailers and the basic causes thereof. The most comprehensive data on this subject are those collected and published annually by the well-known mercantile credit agency, Dun & Bradstreet, Inc. Records from this source indicate that more than one-half of the business failures that occur annually are failures of small retailing businesses. This is explained not so much by the unusually hazardous character of retailing as it is by the fact that the total number of retail establishments is more than three times as great as the combined number of manufacturing and wholesaling establishments. Failures in retailing occur particularly in the smallest sales-volume classes of stores and in the first two or three years of their operation.

Studies of the causes of retailing failures, based on the opinions of informed creditors as reported by Dun & Bradstreet, Inc., indicate that it is relatively rare for a retail business to fail because of reasons which are beyond the realm of managerial control. In one analysis, it was reported that more than 85 per cent of total retail failures were attributed to specific factors broadly grouped under the classification, *inefficient management*.[4] This includes situations in which proprietors lacked the ability to avoid conditions that resulted in an inadequate volume of sales, unusually heavy operating expenses, difficulties in managing accounts receivable or inven-

[4] See Paul L. Brown and William R. Davidson, *Retailing—Principles and Practices* (New York: The Ronald Press Co., 1953), pp. 34–35.

tories, excessive fixed assets, operating in a poor location, or general competitive weaknesses.

An important underlying cause of the vast number of retailing failures that are explained by inefficient management is the fact that it is *relatively easy to enter the retailing field without either the experience or capital* that is necessary for successful operation. In retailing, more than in any other field, many persons with relatively little chance for success manage to get a start. To the extent that it is desirable for the door of opportunity always to be open to all who seek a chance, this fact may be encouraging. But when the costs of failure are considered, it may be that entry into retailing is entirely too easy.

Although many students of marketing and of social progress believe this last conclusion to be sound, no effective way of preventing the opening of stores by persons unlikely to succeed has yet been devised. Proposals such as those urging more careful credit-granting by banks, wholesalers, and manufacturers have been made for years, but there is little valid evidence that credit is harder to secure than in the past except in periods when the total supply of capital is unusually limited in relation to the demand for it. Systems of licensing based upon examinations have been suggested, but it is not believed by many that the probabilities of success can be adequately measured by an examination. If, as has been suggested, a license to open a store were required, some governmental agency would necessarily be charged with the responsibility of determining who should receive a license. It does not seem probable that any such agency could select from many applicants for licenses those whose probability of success would be relatively high. It must therefore be concluded that as yet the various attempts to reduce the failure rate of merchants have met with little success other than through training in merchandising techniques by manufacturers and wholesalers, and perhaps a general increase in the educational level of beginning retailers. Previous experience as an employee of a merchandising concern has also proved an invaluable aid in running one's own retail business.

Large-Scale Retailing

When consumers buy fashion merchandise, they desire to visit stores which can offer extensive stocks and much opportunity to exercise choice in such purchases. Moreover, in purchasing such products many consumers desire to shop around or to compare the offers of competing stores. The grouping of stores, such as occurs in the shopping districts of our cities and towns, offers superior opportunities for such shopping around, and as a result these stores draw their patronage from a wide area. All of these factors have facilitated the development of large retailing units such as department stores and the departmentized specialty stores. Other factors have given rise to the chain store type of retailing, and still others have made it possible

for mail order retailing to reach a status which entitles some organizations in that field to be classified as truly large-scale retail enterprises. Even the modern institution of the supermarket represents a scale of operations that distinguishes it from smaller independent merchants.

There are certain favorable and unfavorable factors that stem from scale of operation and size of enterprise, rather than from the particular characteristics of some one kind of institution such as a department store, chain organization, mail order company, or supermarket. It is therefore appropriate at this juncture to summarize these advantages and disadvantages which all of them have in common.

Advantages of Large-Scale Retailing. One of the most important advantages of scale is the elaborate *division of labor* that results from specialization in effort. Size permits these organizations to employ experts for executive positions. Skilled buyers, advertising managers, accountants, statisticians, and personnel directors are all at the command of such big businesses.

Large establishments can usually afford a much more *extensive departmentization* than can smaller firms. By carefully classifying merchandise and creating separate departments for the sale of each class of goods, the management enjoys not only the advantages of specialization on the part of buyers and salespeople but is also facilitated in the discovery of profitable and unprofitable classes of goods and in a more accurate measurement of the efficiency of department or store managers.

A most important competitive advantage is that of *large buying power.* Since their purchases are large and hence very important to suppliers, large-scale retailing organizations can often circumvent the wholesaler in an economical manner and, by so doing, can obtain more favorable prices than are available to their smaller competitors. Not only are large discounts from list prices secured when big quantities are purchased, but other concessions such as advertising allowances, exclusive rights for distribution, free goods, or the postdating of invoices may also be obtained. While the manufacturer's freedom to quote more favorable prices to large buyers has been somewhat limited by legislation, particularly the Robinson-Patman Act, large-scale retailers still remain in a position to purchase on much more favorable terms than their smaller rivals on purely economic grounds. Further buying advantages are realized through the ability of these companies to employ experts to perform this function.

The *financial strength* of large institutions often attracts investors and facilitates the acquisition of capital required for expansion. Size is also an advantage in making banking connections which may enable the borrower to secure loans on favorable terms. Large financial resources make it possible to take advantage of cash discounts offered by sellers and to attract

vendors who may be led to offer especially favorable terms of sale. In recent years, the great financial strength of large-scale retailers has enabled them to command the most strategic locations in new controlled shopping centers. Shopping center developers prefer to obtain leases from large, financially strong companies because such leases can be used as security in obtaining loans from banks, insurance companies, and other sources of capital for the purpose of shopping center construction.

Many of the larger retailing organizations have effected some operating economies through the *integration of wholesaling and manufacturing activities* with retailing. Many chains, department stores, and mail order companies have established their own warehouses which are operated on an efficient scale and in which are performed the distributive functions of the regular wholesaler, with the exception of personal selling activities which are largely eliminated between these two levels in the channel of distribution.

The *prestige* which results, in part at least, from the great size of the leading chain, department store, and mail order companies is a distinct advantage in attracting patronage. The reputation of such firms is well established, either because of a long history in a given location or the publicity associated with their operations on a widespread geographic basis. This prestige, when accompanied with integration, is particularly suitable for the promotion of private brands of merchandise.

All forms of large-scale retailing benefit from a certain amount of *risk distribution*. Customers are drawn from large areas or many different lines are sold. The organization can usually assimilate severe losses in some departments or operating units, without greatly impairing the profit-making possibilities of the entire organization.

Finally, *experimentation and research* represent types of activity which may prove most effective in increasing efficiency and which, while practical for the large retailer, may be too expensive to be undertaken by his smaller competitors.

Inherent Disadvantages of Large-Scale Retailing. The unfavorable factors incident to large-scale retailing are less numerous than the advantages and for that reason may be stated much more briefly. This should not, however, lead to an underestimation of their importance, because it is these disadvantages that contribute a great deal toward explaining the significance of small-scale operation in our retailing structure. Furthermore, each of the various forms of large-scale retailing has some disadvantages that are peculiar to it, but which are not discussed at this point.

As has been mentioned earlier, one of the weaknesses of large establishments lies in the *absence of close personal contact between the owners or general managers and the consuming public*. Most consumers meet only the rank and file of subordinate employees, rarely the owners or major executives. While the self-interest of routine workers, together with their

training and supervision, may produce some measure of efficiency, hired managers nevertheless usually function with less effectiveness than do the owners of small businesses with their sharpened personal interest in customers.

Another disadvantage consists of *high overhead costs arising out of the complex organization structures* of large-scale enterprises. Some advantages of specialization are offset by lack of close contact between top management and subordinates and may have unfavorable effects upon efficiency. Larger concerns ordinarily have a much greater proportion of nonselling employees than smaller retail organizations. Much of this nonselling labor results from the need for utilizing costly methods of recording and checking the activities of the various divisions and maintaining the minute supervision necessary to fix responsibility, check performance, and minimize waste.

Legal Limitations. All forms of large-scale retailing have been limited, at least to some extent, by *lack of public sympathy*. While the friendly attitude toward the smaller merchant has not prevented the masses from patronizing large establishments, numerous consumers do prefer to deal with the small merchant when considerations of value are approximately balanced. This belief in small business as a manifestation of the American way of life had a more direct bearing upon our legislative history. Numerous enactments have been designed to curb some of the buying power and other advantages of large organizations and to provide, thereby, legal methods of balancing the competitive situation between the large and the small. Noteworthy are the Robinson-Patman Act, and fair trade and unfair trade practices legislation designed to curb uneconomic price-cutting tactics.

The Robinson-Patman Act. While pricing legislation is a matter that is discussed in detail in Chapters 33, 34, and 36, it is important to note briefly at this point the manner in which legislation of this kind has been and is operating to limit large marketing organizations.

The Robinson-Patman Act, a federal law passed by the Congress in 1936, represents an attempt to curb certain uneconomic advantages of large retailers, which they enjoyed merely because of their large size and great purchasing power. There are numerous instances on record in which large-scale buyers have more or less compelled manufacturers to sell to them at prices much lower than paid by wholesalers who supply small independent merchants. The contention of supporters of this legislation is that such manufacturers must then charge wholesalers or independent retailers a higher than normal price to compensate for the abnormally low prices given to large-scale buyers. In order to prevent unjustifiable differences in prices, the Act makes it unlawful for sellers to discriminate in price between different buyers of like grade and quality where the effect of such discrimination may be sub-

stantially to lessen competition, to tend to create a monopoly, to injure, destroy, or prevent competition. In substance, the law provides that *only those price discriminations are allowed which are justified by differences in cost to the vendor.* Thus, in many instances large retailers are deprived of the sizable discounts and other price concessions which they previously enjoyed. Certainly all *secret* discounts are outlawed by this measure. In some cases, however, a manufacturer may show that his economies in selling to large buyers are greater than the discounts given, but in general the effect has been to reduce the buying advantage of the large retailing organization.

Because of their great importance to resources, large retailers have been able to secure substantial allowances for advertising purposes. Numerous manufacturers follow a policy of advertising cooperatively with their retail outlets, with part of the media space cost paid by the manufacturers. This is an established practice that usually works to the benefit of both parties and is above criticism. Objections have arisen, not from the nature of the practice, but from its abuse in the form of unjustified discrimination. Chains and large department stores were able to secure substantial advertising allowances from many companies which did not grant such allowances to small independents. In essence, such discrimination amounts to a subsidization of the big retailer's advertising program at the expense of independents who are not able to obtain comparable discounts. A second major provision of the Act attempted to prevent this kind of discrimination by *prohibiting advertising and all other forms of sales promotional or service allowances, unless they are made available on proportionally equal terms to all customers.* It is perfectly legal for a manufacturer to give a large buyer an advertising allowance amounting, for example, to 3 per cent of such buyer's purchases, but it cannot do this *legally* without making the same percentage allowance available to all of its customers.

Another practice curbed by the Act pertains to brokerage fees. Numerous small manufacturers cannot support their own sales force and hence employ the services of brokers who also serve other manufacturers. In performing the selling or negotiating function for the manufacturer, the broker renders a valuable service for which he is entitled to reasonable compensation. Many large chains and department store buying offices set up subsidiary purchasing companies which were, in effect, *dummy* brokerage offices. They required manufacturers to sell through these subsidiaries and grant to them the usual brokerage fee. In such an instance, the dummy brokerage office is not a representative of the seller, but rather an agent of the purchaser. As a purchasing company seeking out sources of supply, it would be logical to expect that it should be compensated by the buyer rather than the seller. When an organization owned by a buyer obtains a brokerage fee from a seller whom it does not serve, this merely amounts to an unjustified price

discrimination, because other purchasers must pay the manufacturer's factory price with perhaps a brokerage fee *added,* rather than *deducted.* A third major provision of the Robinson-Patman Act was designed to *prohibit sellers of merchandise from paying brokerage fees to other than their own agents.* A broker may only collect a commission or fee when he acts as a bona fide third party, rather than as an employee of the buyer, for services rendered to the principal who pays the fee.

These provisions do not curb any *economic* advantages of large-scale retailers. To the extent that a seller can deal with a large buyer at lower costs of marketing than encountered when dealing with small independents, he can give a lower price. The large retailer can still obtain advertising allowances, but only if the allowances are made available to all of the vendor's customers on proportionally equal terms. It cannot obtain brokerage fees for itself, but this does not place it at a disadvantage with respect to small merchants. The effect of the Robinson-Patman Act has been substantially that of restricting the *power* advantages of giant retailers, i.e., the benefits that they once enjoyed to a high degree because of their ability to wield strength in securing concessions from sellers of goods by coercion. It does not penalize them in any way through curbing natural advantages that they enjoy *because of their ability to perform marketing functions in a more efficient and economical manner.*

State Pricing Legislation. In many of the states, laws have been enacted which restrict the pricing freedom of retail merchants, thereby limiting to some extent the price appeal and price-cutting tactics of some merchants, primarily in the large-scale classification. Other laws have been enacted to place restrictions on the prices at which large buyers can purchase merchandise, when dealing in *intrastate commerce.*

The most common of these are the so-called *fair trade* laws. The first such law was enacted in California in 1931, for the purpose of putting a floor under the resale prices of the branded items of those manufacturers that chose to operate under this type of law. Eventually, 45 states passed similar laws, and they were legalized in interstate commerce originally by the Miller-Tydings Act of 1937 and later also by the McGuire Act of 1952. For reasons which are explored at length in Chapter 34, these laws became highly controversial in the 1950's. In six states, they became unconstitutional or inoperative in their entirety, and in eight more they were declared unconstitutional under the respective state constitutions with reference to nonsigners, so that early in 1957, fair trade laws in some form or another were operative in 39 states.

The general purpose of the fair trade laws is to permit the manufacturer of a branded article to set the price below which the goods cannot be resold to the consumer or at which they must be so resold. This sort of resale price

maintenance has restricted freedom in the retail pricing of goods, if the owner of a brand operates under the law, and thereby has curbed loss-leader policies followed by retailers in attracting trade. In order to establish a resale price under the state laws, a manufacturer must ordinarily obtain a contract with one retailer who agrees to maintain the resale price. In most states, the price is then binding on all other retailers as soon as they are notified of the agreement. Fair trade legislation has been described by opponents as "handicap competition." It has been compared with a cross country race in which "handicaps" are placed on the swiftest, to assure equality of opportunity for retail contestants of varying strengths vying for consumer acceptance in the market place.[5] Protagonists, on the other hand, attribute to it all the qualities that make for healthy competitive business enterprise. Regardless of the intent, these laws have been widely utilized in only a limited number of lines of trade. Although their effectiveness has been limited, they have constituted a force which has enabled some small independent merchants to compete on more nearly equal terms, in the sale of fair-traded items, with large price-cutting competitors.

While the fair trade laws are only permissive, i.e., they merely allow a brand owner to operate under them if he so elects, there are so-called *unfair trade practices acts* which are mandatory. Some 30 states and Hawaii have enacted such legislation, still operative in 26 states and Hawaii, which directly prohibits resale at prices that are deemed to be below cost plus a specified percentage of markup; and attempts have been made in those statutes to set up standards for the determination of "cost" for purposes of the law.

About 19 states, Alaska, and Hawaii, have specific *price discrimination laws* which are in essence state Robinson-Patman Acts. They prohibit the same type of price discrimination as is forbidden in the federal law but apply, of course, only to transactions in intrastate commerce.

The net effect of the federal and state pricing legislation has been that of curbing buying advantages incident to mass purchasing power, and the laws have also rendered it more difficult for large retailers to engage in price-cutting practices designed to make consumers believe they have tremendous operating advantages over independent merchants. It must be remembered, however, that large organizations have not been the only price-cutters. This practice has been important among some small independent merchants, and the laws apply to them with equal force. Because of the limited buying power, somewhat higher operating costs, and less emphasis upon price appeal among independents as a class, the laws are to be regarded primarily as limitations to large-scale operations.

[5] Edward M. Barnet, "Showdown in the Market Place," *Harvard Business Review*, July–August, 1956, p. 86.

Compensatory Activities by Small-Scale and by Large-Scale Retailers

If a person's sympathies are with the small merchant and his thinking is prejudiced in that direction, he may be led unwarily to the conclusion that large organizations will have great difficulty in competing with the small. On the other hand, if one is strongly influenced by considerations of advantages of scale of operations, and if analysis is made strictly in economic terms to the neglect of other social considerations, it might be argued that the small merchant has no justifiable place in a modern mechanized economy. That neither position is tenable is the record of historical experience. Small-scale merchants and large-scale organizations have been able to compete effectively with each other over a period of many decades, largely because of the manner in which the more progressive institutions within each class have adapted to their competitive environment and compensated for their common disadvantages.

Compensatory Actions within Small-Scale Retailing. Over a period of years there has been a host of developments tending to make retail store operation somewhat more efficient. For the most part these developments have stemmed from innovating practices originated from the research activities of large, well-financed retailers. In order for the smaller retailer to survive, he has had to improve his operations in like manner. Ordinarily this has been very difficult to accomplish through individual efforts. Thus the burden has fallen primarily upon groups of merchants with similar interests, or upon other institutions which have identified their own welfare with small-scale business enterprise.

One facet of this development has consisted of activities undertaken by wholesalers. Since small independent merchants constitute their principal group of customers, wholesalers have engaged in a variety of activities to increase their competitive efficiency. As is explained in detail in Chapter 14, it is common for progressive wholesalers to provide various kinds of advice and store operational assistance. This may take the form of merchandising advice, help on store arrangement and display, assistance in modernization programs, provision of accounting aids, sales training help, and numerous others.

The voluntary chain concept is another device which has tended to equalize the competitive situation. By associating themselves with a wholesaler who sponsors a voluntary chain, or by pooling interests with other retailers who wish to establish a cooperative chain organization, small retailers have been able to match large chain rivals in a number of respects. As explained in Chapter 10 where the voluntary chain movement is analyzed at some length, such associations have enabled small retailers to attain greater buying power through a pooling of efforts, and to perform a number of retailing

functions within a central office organization, much in the manner traditional within a chain store administrative office.

A third factor consists of the activities of trade associations. Most progressive small merchants belong to such an association which may provide them with a wide variety of aids. Common services of such associations include the publication of magazines or newsletters which contain information that is helpful in store operation; the collection and exchange of operating cost information used for the scientific planning and control of store expenses; group purchasing of items of store supplies such as wrapping paper and gift boxes; sponsorship of special schools and clinics at which members receive information on recommended business practices; and store display and modernization services.

As explained in the preceding section, public sympathy for the small merchant has resulted in a variety of legislative controls over competitive practices which have curbed certain advantages of large-scale organizations. It has also resulted in various positive measures designed to enhance the market opportunities for small business organizations. While the U. S. Department of Commerce has for many years engaged in a variety of forms of aid to small firms, it was not until 1953 that a special independent government agency was established by an Act of Congress for the express purpose of advising, assisting, and encouraging small business enterprises. In the Congressional legislation which created the Small Business Administration in that year, public policy was stated as follows:

> The essence of the American economic system of private enterprise is free competition. Only through full and free competition can free markets, free entry into business, and opportunities for the expression and growth of personal initiative and individual judgment be assured. The preservation and expansion of such competition is basic not only to the economic well-being but to the security of this Nation. Such security and well-being cannot be realized unless the actual and potential capacity of small business is encouraged and developed.

The principal responsibilities of the Small Business Administration of interest to retailers are: (1) to help small firms gain access to adequate credit on reasonable terms; (2) to assist them with their management problems; and (3) to provide financial assistance when businesses have been damaged or destroyed by disasters such as hurricanes or floods. Much government effort has been expended in studying the peculiar problems of small retailing firms and in disseminating knowledge to help solve them. A wide variety of publications has been issued on merchandising, accounting, and store management topics, and these are distributed free or at a nominal charge. The Small Business Administration also cooperates with local organizations of businessmen and educational institutions in sponsoring educational courses or seminars. These are designed to fill the gaps in the businessman's knowledge so that he can acquire a better grasp of the problems of adminis-

tering a business enterprise. In the 1955–56 school year, ninety such SBA courses were offered in seventy educational institutions throughout the country.[6]

Compensatory Activities of Large-Scale Retailers. Perhaps the outstanding handicap of large retailers is their lack of flexibility in meeting the competitive challenge of small merchants who have close personal contact with their customers and employees. In order to attain some degree of this traditional small-scale advantage, large retailers have tended to increase the extent to which they delegate responsibility and authority to store managers, department managers, and service division supervisors. Whereas it was once common for top management executives to formulate budgets, operating policies, and merchandising plans for the whole organization, it is now common to regard each department in a department store or each store in a chain store organization as a separately managed profit center. Store managers and department managers in progressive large organizations have greater responsibility than formerly with respect to the selection and training of personnel, buying and merchandising planning and control, expense budgeting and control, merchandise display techniques, and related matters. Experience with this type of decentralized management has been varied, but it is believed that it has enabled large national organizations to compete with greater flexibility and with greater effectiveness in meeting situations which vary from one locality to another.

Conclusion. As has been indicated in the preceding chapter, the proportion of total retail sales accounted for by independent merchants has been reasonably stable at about 70 per cent of the total over the quarter of a century covered by Census of Business data. It was also shown that the total number of retail stores has remained relatively stable in spite of very substantial increases in the physical volume of goods distributed through them. While the competitive position of the small merchant appears to be reasonably solid, it is also clear that there has been a marked tendency for the scale of operations to increase within this category. The environment prevailing in the 1950's leads to the conclusion that this will continue to be the case. For one thing, the economy has been characterized by high levels of prosperity, employment, and personal income. So long as such conditions continue, there is less of a tendency for unemployed persons with meager capital and limited managerial resources to attempt to start a marginal retail enterprise. Second, under modern competitive conditions, a higher degree of experience and managerial skill is required to operate a competitive business. Except in rural buying centers and in isolated neighborhood locations, there is little opportunity for the unqualified entrepreneur. Finally,

[6] Wendell B. Barnes, "Activities of the Small Business Administration," *Georgia Business*, June, 1956, p. 4.

the capital resources needed to operate a competitive establishment have grown beyond the reach of many would-be proprietors. A modern store requires investment in many kinds of expensive display fixtures, lighting systems, air conditioning equipment, cash registers, and other items that may have been considered "store luxuries" by the average retailer of the 1920's or 1930's. In order to amortize the investment in such equipment over a reasonable time period, some assurance of a fairly high volume of sales should be in evidence. For these reasons, it is believed that relatively small independent merchants will continue to dominate the retailing structure in future years but, within the independent merchant category, there will continue to be a trend toward larger sales per establishment, thus permitting the more efficient utilization of managerial ability and capital invested in the business.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:

   a) small-scale retailing
   b) explicit costs
   c) price discrimination
   d) fair trade laws
   e) unfair trade practices acts
   f) advertising allowances
   g) brokerage fees

2. Compare, in outline form, the advantages of small-scale retailers and those of large-scale retailing organizations. Make a similar comparison of the disadvantages of each class. Does this outline contribute to your understanding of the status of each class in our retailing structure? Explain.
3. Why should a rather general topic like "Failures in Retailing" be discussed within a section of this chapter which deals specifically with "Small-Scale Retailers?"
4. What relationship exists between retail store failures and managerial ability? Explain.
5. How can the question of location in planned shopping centers be related to the matter of financial strength of large retailing organizations?
6. Do you see any relationship between full employment, prosperous and expanding business, and relative stability in terms of number of retail establishments?
7. State the three major provisions of the Robinson-Patman Act. Explain each provision by illustration of some type of competitive practice that would be illegal under this law. To what extent, if any, has the Robinson-Patman Act curbed so-called "natural" or "economic" advantages of large scale retailers?
8. What types of laws have been passed by various states with a view to limiting freedom in retail pricing?
9. In what sense may "fair trade" laws be described as "handicap competition"? What, then, is fair about "fair trade"?
10. Competition in retailing varies from one market to another. How can large, centrally administered chain organizations compete with independent merchants who pursue different tactics in different markets?

11. What types of cooperative or social activities have operated to improve the competitive position of small retailers?
12. Explain the nature of the services of the Small Business Administration. Is it fair to big business or to consumers for the federal government to spend money specifically to aid small business? Explain.
13. "Many retail stores sell less than $25,000 worth of goods in a year. After the cost of the goods has been deducted and the expenses such as rent, heat, and light have been paid, there is little left for salary or wages. The existence of these stores, therefore, means the existence of hundreds of thousands of proprietors earning very meager incomes. From a social point of view, it is desirable to let chains and large independents compete freely so that these small businesses will be forced to close. This mass of labor could then migrate to more efficient industries which are in a better position to pay high wages." Analyze fully, evaluating all of the implications.
14. Is small-scale retailing desirable in an economy which aims at maximizing efficiency in its productive and distributive system? Would not the efficiencies of large-scale operation make these institutions obsolete?

9

DEPARTMENT STORES

At the very heart of the retail shopping district of all major cities are to be found large departmentized institutions which are well known as department stores to practically all consumers residing within the trading area. These stores are of great public interest not only because of the vast number of customers served by them but also on account of their unusual size, broad range of merchandise offerings, community leadership, and market dominance in certain lines of goods handled by them. They are, furthermore, one of our most mature forms of retailing institutions, constantly in the public eye through various forms of advertising and publicity.

Definition. *Department stores are retail organizations which carry several lines of merchandise such as women's ready-to-wear and accessories, men's and boys' clothing, piece goods, small wares, and home furnishings and which are organized into separate departments for the purpose of promotion, service, accounting, and control.* Departmental organization distinguishes them from the general store. An additional distinction is their common emphasis upon shopping lines. Department stores are distinguished from specialty, single-line, and other departmentized stores by the wide range of merchandise handled; and from variety stores, by the wide price range of their merchandise. A widely held conception is that a department store is an unusually large retailing organization. In conformance with this viewpoint, the Bureau of the Census limits this classification to otherwise qualifying individual establishments that have twenty-five or more employees.

History. The department store in the United States is primarily a product of the period since the Civil War. The East, with its concentrated population, was the area of largest department store development until the last quarter of the nineteenth century, when rapid improvement in transportation facilities and the growth of cities led to the establishment of large numbers of

department stores in other sections of the country. As the department store is a product of urban conditions, its development has paralleled the growth of cities. Use of advertising in extending trade areas, ordering by telephone, development of delivery systems, and increased style elements in merchandise are additional factors accounting for the growth and multiplication of department stores. The period since 1900, however, has been characterized by the establishment of fewer new stores than the quarter-century immediately preceding it. This decline in the rate of new enterprises should not be interpreted as indicating any decrease in the importance of the department store, since this period has witnessed great enhancement in the sales volumes of established stores of this type.

The country general store cannot be regarded as the prototype of the modern department store. The motives behind the patronage of customers are entirely different. Patronage of the general store depends largely upon its accessibility, while that of a department store is inspired by the opportunity to inspect a variety of merchandise of any one class or to combine purchases of several classes of goods, such as shoes, towels, and piece goods, under a single roof.

Many department stores were developed from dry goods stores, a few descended from general stores, and some had their beginning in men's or women's clothing stores. A few represent consolidations of single-line stores. The origin of a particular department store has some significance, since it may materially affect its later patronage. Those which had their origin as men's clothing stores frequently enjoy a larger patronage in men's wear than those developing from drygoods stores, resulting from a well-established reputation in its original line and because the other lines are built around the original line that constitutes the nucleus for the new store.

Importance of Department Stores. Interesting evidence bearing upon the quantitative importance of the department store as a retailing institution comes from the Census of Business for 1954. In that year, there were 2,761 retail establishments classified as department stores. This group, representing only a small fraction of 1 per cent of all retail stores, accounted for $10,557,843,000 of total sales volume, which amounted to 6.2 per cent of the total sales of all retail establishments. It is not surprising, therefore, to learn that several department stores have been able to make sales considerably in excess of $100,000,000 each in a single year and that there is a substantial number of stores with annual sales in excess of $50,000,000 each. Employment within this store classification amounts to about one out of every ten of the total number of paid employees in all retail stores.

In the period following World War II, department stores have tended to decline in sales volume importance, relative to the total retail trade structure. While the sales volume reported for department stores in 1954 was greater

than in any previous Census of Business year, the ratio of 6.2 per cent of total retail sales was a decline from 7.3 per cent in 1948, and this was appreciably lower than experienced during the 1930's when department stores accounted for about 9 per cent of the total. The principal reason for this relative decline is that consumer expenditures for types of merchandise commonly handled in department stores have not kept pace with other categories of expenditures in retail stores, notably those connected with the automobile and its operation. If the comparison of department store importance is confined to the so-called "department store market" (i.e., lines of merchandise commonly sold by department stores and lines in which department stores account for a significant share of the total consumer expenditures), it is apparent that such institutions have occupied a very stable competitive position. An exhaustive research study on this subject reveals that, over the 1929–1955 period, department stores have rather consistently accounted for about 22 to 24 per cent of the total sales within this "department store market."[1]

When considered from another viewpoint, the department store is of institutional significance far beyond its importance as measured by sales volume. Such stores are high-prestige institutions which attract shopping traffic to central shopping districts of cities. With their specialized personnel and financial strength, they are able to innovate and experiment. They are, accordingly, frequently recognized as leaders setting the general tone of retailing in the community.

Classifications and Special Characteristics

The department store field includes a variety of different kinds of institutions when classified by ownership, method of operation, or clientele served. In addition, there are a number of unique features that characterize department store retailing to a greater extent than other types of stores. Some of these are examined in the following paragraphs.

Classes of Department Stores: Ownership and Operation. When department stores are classified on the basis of ownership and operation, several distinct groups are recognized. First are the *independents that have no ownership affiliation with other department stores.* In 1954 the stores in this group represented about 26 per cent of all department stores and accounted for about 24 per cent of total department store sales volume.

[1] Robert D. Entenberg, *The Changing Competitive Position of Department Stores in the United States by Merchandise Lines,* an unpublished doctoral dissertation deposited in the library of The Ohio State University, 1956, Table 12. The department store market, as defined in this study, includes all merchandise lines generally sold in department stores, provided that department stores accounted for 5.0 per cent or more of the total market sales within these lines.

Within the multi-unit category, which comprises some 74 per cent of all units and accounts for 76 per cent of the sales volume, several distinct types may be differentiated. *Department stores operated by regular retail chains* are centrally owned and strictly supervised through central or district offices. Illustrative are the larger or so-called "Class A" stores of Sears, Roebuck and Company, the J. C. Penney Company, and Montgomery Ward and Company. A large amount of the buying is done by central office executives who, as a rule, make all resource contacts. Within each such company, individual stores usually must conform to standardized merchandising, service, and operating policies, and they tend to have somewhat similar physical appearance and layout. Stores within this ownership classification are operated in a much different manner than those in the other classes here enumerated, and they have a greater resemblance to regular corporate chains, which are discussed in the following chapter, than to independent or ownership groups of department stores.

Ownership groups are a second type of multi-unit organization. While technically qualifying as chains on the basis of ownership, they differ from regular chains in several ways. In some cases, all stores within such a group are owned outright; in others, only a controlling stock interest in individual stores is owned by a central holding company. These groups, unlike regular chains, have usually expanded their interests by purchasing established independent stores which, in most cases, have retained their original identity, operating personnel, executives, and operating policies. The degree of central control varies but the general manager of an individual store usually has more freedom than managers in regular chains. Illustrative of ownership groups is Federated Department Stores, Inc. The major stores owned and operated by this company include the following: Abraham & Strauss, Brooklyn; Bloomingdale Bros., Inc., New York; Wm. Filene's Sons Co., Boston; The F. & R. Lazarus & Co., Columbus, Ohio; The John Shilito Co., Cincinnati; Foley Bros. Dry Goods Co., Houston; Halliburton's, Oklahoma City; The Boston Store, Milwaukee; Sanger Bros., Inc., Dallas; and Burdine's, Inc., Miami. In 1955, there were as many as ten ownership groups, each with an annual sales volume in excess of $100,000,000.[2]

A third multi-unit type consists of the *branches* which are operated by many independent department stores as well as by some of the individual stores within ownership groups. Branches may be distinguished from the

[2] The following companies are in this group (1955 sales in millions are given in parentheses): Allied Stores Corporation ($581.9); Federated Department Stores, Inc. ($537.7); May Department Stores Co. ($494.4); R. H. Macy & Co. ($376.4); Gimbel Brothers, Inc. ($325.0); City Stores Company ($251.8); Marshall Field & Co. ($201.3); Associated Dry Goods Corporation of New York ($189.8); Mercantile Stores Co., Inc. ($138.8); Bullocks, Inc. ($126.5). Additional information concerning these and other such groups may be found in *Moody's Manual of Investments, Industrials.*

units of regular chains in that they are satellites of a large store and are administered by the operating executives of that so-called main or parent store rather than by central office executives. While a few department stores have operated branches for a number of decades, branches are essentially a modern development—one that reflects an accelerated decentralization movement in the retail trade structure of metropolitan areas.

There is an important limitation in the classification just presented, namely, that all stores within the various multi-unit types are not necessarily department stores. Many of the smaller stores operated by regular chains such as Sears, Roebuck and Company do not carry a sufficient range of departmentized merchandise to be so considered. The same is true of many individual stores within certain ownership groups. Some of them, including many department store branches, are more properly considered as departmentized specialty stores.

Classes of Department Stores: Clientele. Department stores may also be classified on the basis of the clientele to which they cater. In larger cities especially, it is difficult for a store to appeal with equal effectiveness to all economic classes. Many consumers with large incomes hesitate to mingle, when buying, with the less prosperous. Moreover, stores catering to prosperous groups find it necessary to create physical surroundings of elegance consistent with the merchandise offered and the tastes of their patrons. Services and publicity must be adapted to the tastes of customers to attain maximum effectiveness. Advertising copy and services which may be very effective in selling quality goods to a discriminating clientele may be too costly or even ineffective in promoting sales to persons dominated by a desire to buy as cheaply as possible and who, while not immune to the appeal of quality, may nevertheless be forced to give major consideration to prices.

In many cities three classes of department stores will be found. One store or group of stores will sell medium-high- and high-priced merchandise with the general prices and quality level distinctly above average. Such stores are in competition with the high-class specialty shops and cater to the more prosperous economic classes. Another store or group of stores, selling medium-high- and lower-priced merchandise, will center its appeal on the great middle-class group. As was shown in Chapter 5, great increases have occurred in the size of the so-called middle-income class and in the volume of purchasing power at its command. For this reason, department stores appealing to this group have experienced the most notable expansion. A third group of department stores places major emphasis upon lower price lines of merchandise, with the objective of appealing to those in the lower-income strata, or to other families for whom price is a paramount purchasing consideration. Operation of a basement department, as discussed in a later section, often represents an attempt to cater to a different economic group than that served by the regular main store departments.

In smaller cities and towns, the volume of business usually does not permit of such a specialization of stores as that which occurs in larger cities. Small-town department stores must appeal to the community and not to any one class.

Kinds of Merchandise Sold. Department stores carry a wide range of merchandise, including shopping, specialty, and convenience goods. Women's and children's ready-to-wear occupies a prominent place and dry goods departments are important. The convenience goods are, in the main, those purchased by women, and the specialties are also largely those which appeal to the housewife, such as electrical household appliances and equipment. Shopping goods are the most important class of goods sold. As illustrated by the data in Table 13, the sale of women's ready-to-wear and ac-

TABLE 13

SALES BY MERCHANDISE LINES AND STORE DIVISIONS IN DEPARTMENT STORES, FOR SELECTED SALES VOLUME CLASSES OF STORES—UNITED STATES: 1954

Line of Merchandise or Store Division	Per Cent of Sales by Size of Store (in millions)		
	$1–2	$5–10	Over $50
Main store division:[a]			
Piece goods and domestics	9.5%	6.5%	6.0%
Smallwares, toilet goods, notions and novelties	9.0	9.8	9.6
Women's, misses', juniors' ready-to-wear	26.0	22.3	18.7
Ready-to-wear accessories	27.0	20.7	18.7
Men's and boys' clothing and furnishings	9.0	11.4	10.8
Home furnishings	17.0	19.0	25.3
Miscellaneous	2.5	10.3	10.8
Total sales of main store division departments	100.0%	100.0%	100.0%
Total sales of basement store division as a per cent of total store sales	[b]	8.0%	17.0%
Total sales of leased departments as a per cent of total store sales	7.5%	8.0%	3.0%

[a] Percentage distribution data do not add exactly to 100 per cent in all cases because of rounding.

[b] Stores in this sales volume class usually do not have separate basement store divisions.

Source: Compiled from data by Harvard University, Graduate School of Business Administration, Bureau of Business Research, *Operating Results of Department and Specialty Stores in 1954* (Boston: Harvard University, Division of Research, 1955), Bulletin No. 143, pp. 26, 32. Although the data are for 1954, they are deemed typical for other years as well.

cessories and of piece goods and domestics is of greater relative importance in smaller department stores. The largest department stores place more emphasis on the sale of smallwares, home furnishings, and miscellaneous departments such as toys, sporting goods, cameras, and restaurants.

Although department stores as a rule sell men's clothing and furnishings, they are at a definite disadvantage in selling to men, who are in many

instances reluctant to buy in stores frequented by large numbers of women shoppers. As a matter of fact, the larger percentage of men's furnishings sold in department stores is purchased by women who select such goods for members of their families. This is especially true in medium and low-priced merchandise sold to consuming groups in which men have little leisure to make their own purchases.

Leased Departments. The practice of leasing one or more departments to outside operators is most common in department stores. While not all department stores have leased departments, the usual situation is that some half-dozen departments are operated by outsiders, and in a few stores twenty-five or more departments are operated in this manner.

Leasing concerns are both chain and independent. Some chains have made great progress and now operate numerous departments in stores all over the country. Among regular merchandise departments, those most commonly leased are millinery, shoes, furs, rugs, sewing machines, vacuum cleaners, wallpaper and paints, jewelry, automotive goods, and books. Other departments in which leasing is generally important are in a professional, service, or food category and include photographic studios, beauty salons, optical departments, lending library, shoe repair, watch and jewelry repair, hosiery repair, and restaurant, luncheonette, and baked goods departments.

The common plan of operating leased departments is as follows. Outside organizations, chain or independent, make arrangements with the department store management to operate one or more departments. The outside organization buys all of the merchandise for the leased department, provides salespeople, and operates the department as one of the departments of the store. Usually the public does not know that the leased department is in any way different from any other department in the store. The store owner supplies space, light, heat, credit, and delivery service, and in return receives a definite percentage (usually between 10 and 20 per cent) of the sales made in the leased department or some stipulated sum.

A number of circumstances have contributed to the leasing of departments. In the case of oriental rugs, a highly specialized knowledge is necessary for successful operation, and many department stores find it difficult to secure employees skilled in the trade. Moreover, even if a satisfactory department manager can be secured, the general management may lack the knowledge necessary to provide adequate supervision and control. In many instances losses incurred in the operation of particular departments have led to their later operation on a leased basis. Sometimes extreme style risks, as in the case of millinery, prompt the management to lease a department to someone more competent to assume these risks. Some operators of chains of leased departments can purchase in larger quantities and maintain better

market contacts than can the stores from which they lease. This is particularly true when the volume of business of any one store is too small to employ skilled buyers or to finance an adequate number of buying trips and the maintenance of necessary market contacts.

Basement Store Divisions. A somewhat unusual institutional feature is that most medium-sized and larger department stores have a basement store consisting of a separate group of departments handling merchandise in price lines lower than those carried in the main store departments. Where basement stores are used, this part of the business is usually organized separately from the main store division and is operated independently of it, except that the activities of the managers of the two parts of the business are coordinated at the top management level (see Figure 5).

Operation of a basement store is not common among the smaller organizations. Such stores often have a basement floor salesroom and use it for the purpose of housing merchandise departments that do not duplicate the same general type of merchandise as is found in other store departments. As shown by the data in Table 13, basement divisions are of greater relative importance in large stores than in medium-sized stores, accounting for about one-sixth of the total sales volume in the former class.

By handling merchandise in the lower price lines, featuring frequent bargain sales, purchasing and offering considerable distress or job-lot merchandise, and sometimes by offering more limited services, basement divisions are able to compete more effectively with other price-appeal and limited-service forms of retailing. From this it must not be inferred that the basement store is patronized altogether or largely by a different class of customers than the main store. While such may have been the original intention in establishing basement stores, to which even separate entrances were provided to avoid commingling of main store patrons with basement store customers, this distinction in source of patronage has largely disappeared.

Departmentized Specialty Stores. The departmentized specialty store is a retail store carrying men's or women's ready-to-wear, or both, and a full line of accessories. Its relatively large size makes it possible to departmentize its operations and to organize it practically as a department store. It differs from a regular department store principally because it does not sell furniture or home furnishings, usually handles no piece goods or domestics, and concentrates its merchandising efforts on apparel and accessories. A number of such stores exist in all principal cities and they are usually located in the same part of the shopping districts as department stores, since both institutions compete for much of the same trade.[3]

[3] Typical departmentized specialty stores are those affiliated with Specialty Stores Assn., a cooperatively owned resident-buying service for stores of this type. Its members include the following: B. F. DeWees, Inc., Philadelphia; Richard Healy Co.,

Departmentized specialty stores find their market in the opportunity to center their efforts on style clothing. They can establish buying connections in the market centers which give them just as effective representation as that secured by department stores. But, unlike the latter, they are not forced to operate a number of losing departments merely because the customer expects to be supplied with a wide variety of merchandise or services. Furthermore, they can center their efforts on profitable merchandise and on the development of a clientele of customers who believe the particular store to be distinctive and the best source of style apparel. One factor making for relatively high costs, however, is the large proportion of style goods which characterizes stores of this type. Direct sales, advertising, display, and other costs are greater than when a larger variety of merchandise is carried.

Departmentized specialty stores suffer from some of the same handicaps as the department store. Personal contact with customers is not as effective as in many of the smaller establishments. Size also brings expenses which are not found in the smaller stores selling competitive merchandise. Advertising and display costs are as high as in department stores. But their ability to buy more effectively than the smaller shops and the other advantages mentioned above make it possible for them to operate successfully with somewhat lower costs than those incurred by department stores and with costs possibly as high as or higher than those of competing small shops.

From the foregoing, it is evident that large departmentized specialty stores are very similar to department stores. Thus, the following discussion may be regarded as characteristic of both classes of establishments, with proper qualifications for the somewhat more limited range of merchandise carried by the departmentized specialty store.

Analysis of Competitive Position

The competitive position of department stores can be evaluated through a consideration of their strengths and weaknesses in comparison with those of competing types of retailing institutions.

Advantages of Department Stores. The competitive advantages of department stores are of two classes: those which are peculiar to department stores and those which are common to all forms of large-scale retailing and which are inherent in size of operation.

Worcester, Mass.; Frank R. Jelleff, Inc., Washington, D. C.; L. L. Berger, Inc., Buffalo; The Addis Co., Syracuse; Neusteter Co., Denver; Chas. Livingston & Sons, Inc., Youngstown; The E. T. Slattery Company, Boston; Stern and Mann, Canton; The Union, Columbus, Ohio; Harzfeld's, Kansas City, Missouri; The J. J. Haggerty Stores, Los Angeles; Jonasson's, Pittsburgh.

The Wm. Filene's Sons store of Boston, although an outstanding example of a specialty store, is not typical in size, since its scale of operations exceeds that of most department stores and for many reasons should be regarded as a department store.

Distinctive Advantages. One advantage of distinctive institutional character is the very *wide range of merchandise sold.* Many of our largest stores have 150 or more merchandise departments, and even among the smallest department stores the number of separate departments is rarely less than 25. This facilitates consumer shopping in that the ability to buy a large variety of goods in one place is a time-saver and in other ways appeals strongly to consumers. Moreover, one line of merchandise may effectively promote the sale of other lines. An advertisement featuring living-room furniture may attract many purchasers who may also buy draperies as the result of effective window and interior displays and good suggestion selling. Customers attracted by a sale of coats may purchase novelty jewelry, and shoe customers may respond to displays of hosiery.

Another major advantage peculiar to department stores consists of the benefits derived from the *wide range of customer services* which are offered. In addition to such services as delivery, liberal adjustments, and several forms of consumer credit, which are not particularly distinctive, most department stores offer a variety of unique services including fashion shows, the maintenance of lounges and rest rooms, children's play rooms, nurseries, telephones, and libraries. Some even offer rooms where women's organizations may hold meetings, and in certain instances, stores offer entertainments such as musicals or space for displays by local art clubs. These services may be very effective in building good will and prestige and in bringing many customers into the store. This variety of services, whether connected with the sale of goods or offered for the convenience and enjoyment of shoppers, exerts a strong appeal.

A third distinctive advantage consists of the *highly public, exposition-like character* of department stores. Everyone feels free to enter such establishments and roam about at will even when no purchase is contemplated. Department store managers attempt to capitalize on the store traffic thus generated by continually creating an atmosphere of buying excitement. This is done by layout planning, attractive displays, use of demonstrations, and special effects created at various seasons such as at Christmas, in the spring or Easter season, and in the fall at school-opening time.

Peculiar Advantages of Size. While the department store generally enjoys the advantages of division of labor, departmentization, buying power, financial strength, integration, prestige, and experimentation and research which have already been discussed in the treatment of large-scale retailing, some of these take an unusual form in the department store and are deserving of additional comment.

The department store type of *division of labor* differs considerably from that ordinarily found in a chain store organization, unless of course the chain is composed of department stores. Because of the size of the individual

establishment, a complex form of organization (see Figure 5) is the general rule. Selling specialists number about one-half of the total employees in medium-sized stores and only about one-third of the labor force in the largest stores. By such specialization, salespeople can develop a very high degree of product knowledge and selling skill. The remainder of the organization provides for stock clerks, merchandising experts, advertising and display specialists, credit personnel, accountants and accounting clericals, personnel specialists, training supervisors, morale managers, warehouse employees, janitors, porters, elevator operators, tailors, carpenters, watchmen, detectives, researchers, truck drivers, appliance installation experts, comparison shoppers, and so on. In fact, almost every kind of skill may be found within the establishments operated by department stores. Individual units operated by chains, on the other hand, are not necessarily large, and the performance of multifarious activities is often the responsibility of a single individual.

The department store also differs from the chain with respect to *risk distribution.* The department store is essentially local, at least with respect to a trading area, hence it does not benefit from a widespread geographic distribution of risks. Its risks are distributed instead by virtue of the widely varying types of merchandise sold. For example, a loss in the shoe department may be offset by a particularly favorable showing in women's coats.

While all forms of large-scale retailing can engage in *extensive advertising,* it is characteristic of department stores to dominate the advertising in local newspapers. Because of the large amount of space used, competitive institutions find it difficult to make a comparable impact upon the public. Many such stores also play an active role in community affairs, and because of the large sums expended for advertising, obtain much "free" publicity for these activities which are often interpreted by the layman to be of an entirely charitable or social-interest character.

Disadvantages of Department Stores. Some of the most important disadvantages of department stores have already been indicated because they are primarily attributable to size of enterprise. As large-scale retailers, such stores suffer to some extent from lack of personal contact between top management and consumers and from complex supervisory procedure in the organization structure.

In addition, there are limitations which are rather distinctively characteristic of department stores. One of the most serious of these is *a very high operating expense ratio.* As shown in Table 14, small, medium-sized, and large department stores all incur operating expenses which are typically about 33 per cent of sales. Contradictory as it may seem, the very services from which department stores derive a competitive advantage are also largely responsible for these high costs of doing business. Actually, department store operating costs are higher than for any other important form of

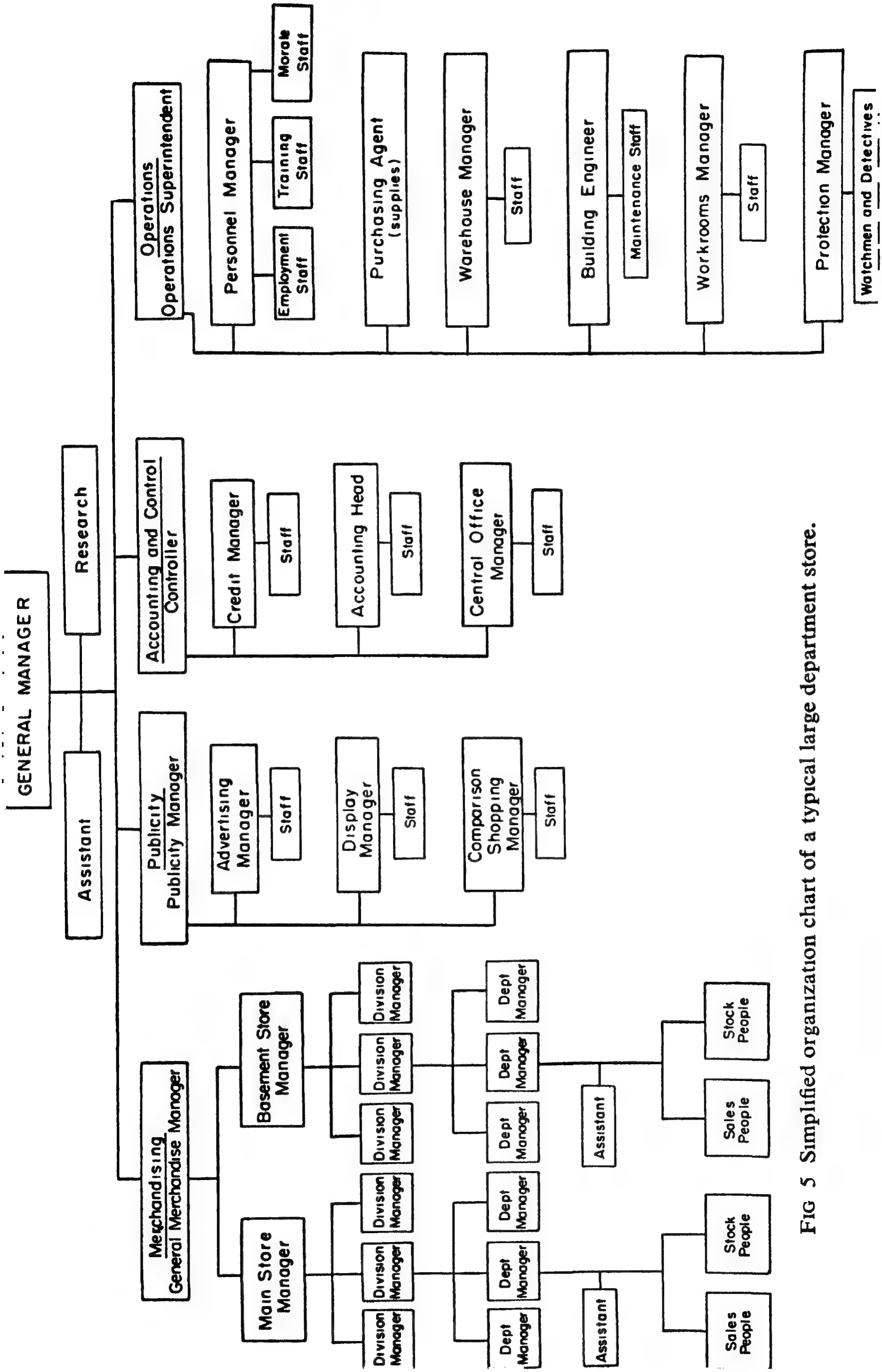

FIG 5 Simplified organization chart of a typical large department store.

TABLE 14

TYPICAL MERCHANDISING AND OPERATING COST RATIOS FOR THREE SALES-VOLUME CLASSES OF DEPARTMENT STORES—UNITED STATES: 1954

Item	Annual Sales in Millions		
	$1–2	$5–10	Over $50
Merchandising Data:			
Original Markup %[a]	39.0%	39.1%	38.5%
Markdowns—% of sales[b]	7.0	6.4	5.6
Gross Margin of Profit—% of sales[c]	36.2	36.6	36.0
Customer Returns and Allowances—% to gross sales	5.4	6.3	9.8
Expense Data by Functional Classifications: (% to sales)			
Administrative Expense[d]	8.8%	7.4%	7.1%
Occupancy Expense[e]	6.1	6.0	5.5
Advertising and Publicity Expense	4.1	4.4	4.1
Buying Expense[f]	4.4	4.7	4.4
Selling and Delivery Expense	10.0	10.0	11.6
Total Operating Expense	33.4	33.0	32.6

[a] The difference between the total of all original retail prices and the invoice cost of goods plus inward transportation, expressed as a per cent of the total of all original selling prices.
[b] The dollar amount of reductions from original prices expressed as a percentage of net sales.
[c] The difference between net sales (after markdowns and customer returns) and the total cost of goods sold. Total cost is computed by adding to invoice cost the sum of transportation cost and workroom and alteration costs and subtracting the amount of cash discounts earned on purchases. Because of the influence of alteration costs and cash discounts and because the ratios are computed on a different retail base, the difference between the original markup and the gross margin is not the equivalent of the markdown percentage.
[d] Includes executive, accounting, accounts receivable, and credit expenses.
[e] Includes rent or real estate costs, operating and housekeeping, fixtures and equipment, and heat, light, and power costs.
[f] Includes the expenses of merchandise management and department management (buyers and assistants) and receiving and marking expenses.
Source: *Departmental Merchandising and Operating Results of Department and Specialty Stores* (New York: The National Retail Dry Goods Association, 1954 ed.), p. 2. This annual source contains much more detailed statistical information for these and other classifications of department stores.

retail store operation, except for a very limited number of highly specialized stores. In addition to the services rendered, costs are also high because of the complexity of organization structure and the accompanying high overhead costs associated with supervision, systems, and recording believed necessary to control operations. All of the expenses typically experienced by such stores must, of course, be recovered from sales, and this circumstance limits the store's freedom with respect to maintaining prices that are competitive with more limited-service forms of organization.

Since it is a service that is reflected in a high operating cost ratio, the department store's problems with respect to *customer returns* may be viewed as another disadvantage. In the largest stores, for every $1,000,000 of merchandise purchased by customers, nearly $100,000 is returned to the store or must for one reason or another be *credited* to customers' accounts. Because of the store's liberal policies with respect to adjustments, many customers abuse the privilege. Many women apparently complete their shopping after taking several items home from the store. While some of these

returns are unavoidable and some others are due to poor salesmanship or overselling on the part of the store's employees, many of them cannot be justified on such grounds. A large part of this returned merchandise can be sold only at marked-down prices and some of it is not resalable at all.

Another problem relates to the extent of *markdowns*. A large portion of the merchandise is never sold at its original retail prices but must be reduced and moved out of the store in clearance sales. Markdowns are not unique among department stores, for they exist in all forms of retailing. They are of greater magnitude in department stores, partly because most such institutions are operated according to policies which require that complete assortments be carried through the peak of each selling season. On a storewide basis, the amount of reductions from original retail prices is about 6 per cent of sales (see Table 14). In other words, for every $1,000 of net sales the store has taken about $60 in price reductions. In some departments, such as women's better dresses, the ratio is three times this amount. In large measure this may be attributed to the alleged fact that "initial marking of high style lines is often experimental until the trend of demand becomes fairly evident."[4] The pricing process is therefore complicated by the necessity of providing some additional margin to allow for anticipated price reductions, which can rarely be estimated with great exactitude. Furthermore, the consumer's anticipation of clearance sales leads to a fairly common reluctance to purchase merchandise at original prices.

The high expense ratio and the need for allowing a sufficient margin to cover markdowns necessitates an original markup of about 40 per cent of original prices in most regular department stores. This markup is higher than that required by many types of competitive, limited-service, price-appeal establishments. To overcome such a disadvantage, the department store must do an unusually outstanding merchandising job, anticipating consumer wants and bringing in desired offerings in broad assortments in advance of competitors who operate on a lower margin.

Many department stores, because of their central location in large cities, also suffer from *traffic congestion* and lack of parking facilities. It is time-consuming and often expensive for the consumer to reach the store. Because of the larger proportion of people now living in suburban areas and the increased demands upon the time of women, many of whom are employed, there is a growing trend to shop in specialty stores in outlying shopping districts.

Finally, though the location of merchandise may be clearly indicated, the very size of many department stores makes for *confusion* in shopping and for the preference on the part of many consumers to patronize smaller, more specialized establishments. The constant shifting of departments ag-

[4] Q. Forrest Walker, "Some Principles of Department Store Pricing," *The Journal of Marketing*, January, 1950, p. 533.

gravates the situation. Again, the same kind of merchandise is often carried in several different departments in widely scattered locations with the result that consumers must do a large amount of in-store traveling in order to view the establishment's complete assortment. While store executives justify this rather common practice on the basis of needing separate departments for the purpose of catering to different income or style-interest groups of customers, it is nevertheless a practice that is resented by many consumers because it contributes to fatigue in shopping and to starved stocks in any one of such departments.

Newer Aspects of Department Store Competition. Until about the late 1940's, most department stores found that their competitive orbit was limited rather substantially, although not altogether, to rivalry with other department stores and shopping goods stores in the apparel and home furnishings classifications. Since that time many changes have occurred which have brought the department store into more strenuous rivalry with other types of institutions. Most of the newer forms of department store competition are discussed elsewhere in this text; hence, it is deemed adequate to enumerate them but briefly at this juncture. Of very substantial concern are discount houses which operate in many urban centers, featuring branded merchandise at significant reductions from retail list prices. Second, with the growth of population in suburban markets, many department stores lost patronage to smaller stores located in planned shopping centers constructed in such areas. Third, a number of leading limited-price variety chains, which had traditionally depended on cash-and-carry sales made to walk-in traffic, greatly expanded their range of merchandise offerings and price lines, engaged in vigorous newspaper and other local advertising, and offered installment credit and delivery service. Fourth, major catalog mail order companies provided telephone order service in large cities and offered rapid delivery service through the facilities of local retail merchants' delivery organizations.

In self-defense, a number of measures have been used successfully by various department stores. To cope with discount house retailers, some of them have held frequent or continuous warehouse sales at which appliances and other items are sold at greatly reduced prices under conditions of limited customer service. Discount house competition has also forced a re-examination of the department store operating cost structure. During the early 1950's, most large department stores had embarked upon elaborate programs of expense control and cost reduction. In many cases, this has involved a survey of traditional department store services to determine which ones are used by only a small percentage of the consuming public and, for that reason, might be eliminated or placed on a self-sustaining basis by specific charges for them.

Suburban competition has been met partially by the construction of branch units of downtown department stores. After some considerable study

of suburban retailing trends, most department store executives have reached the conclusion that the central business district stores held an attraction for consumers that could not be rivaled in any but the most gigantic types of planned suburban shopping centers. Consequently, millions of dollars have been invested in the modernization of the physical plants of downtown establishments to enhance their customer appeal. Department store executives have been among the most active civic promoters for revitalization of central business districts. This movement has become of such great national significance that the National Retail Dry Goods Association in 1956 organized a "downtown development committee" to aid local groups of department store merchants who wish to embark upon such programs. Provision of downtown parking facilities and additional night openings in central business districts are among other related competitive methods.

In order to cater to consumers who wish to buy without visiting the shopping district, many department stores have expanded their telephone and mail order selling services. This has been particularly pronounced during the Christmas merchandising season, at which time it is common for department stores to issue very large, well-illustrated catalogs in which most store departments are represented. With a view to obtaining more consistent patronage from a somewhat broader segment of the consuming public, new forms of credit services have been inaugurated. Some department stores offer three or four types of charge accounts or instalment payment plans designed for different kinds of purchases and for the situation of families in varying economic circumstances. Another outstanding development has been the increased attention devoted to basic research in merchandising, which has resulted in better executive training along the line of offering assortments which are more in harmony with the buying wants of the store's clientele.

Future of Department Stores. Department stores have certain inherent competitive advantages and are a well-established part of our retailing structure. As was pointed out earlier in this chapter, over the period 1929–1955 they have accounted for about 22 to 24 per cent of the total market sales in the kind of goods commonly sold in such stores. This suggests that they are a mature type of institution, one which is already serving all segments of the consuming public that wish to buy from that type of store. For this reason, it is not expected that they will increase their share of the market for department store types of merchandise. Indeed, it is apparent that they will have a struggle to hold their own in the face of newer forms of competitive activity. The initial success of various defensive measures briefly discussed in the preceding paragraphs suggests, however, that they are sufficiently flexible to maintain their position. An important reason for optimism on this score is that the top management staff of our major department stores in-

cludes much of the best merchandising talent in the United States. Still another reason is the great financial strength of most such organizations, which permits them to engage in costly experiments and in long-range research activity.

In relation to the total economy, it may be recalled that department stores have experienced a declining position. If the high and increasing levels of consumer income characteristic of the mid-1950's extend over a span of several decades, it is likely that department stores will continue to occupy a more limited place in the total retail trade structure. As consumers have more income available to spend on types of merchandise not commonly sold in department stores, much of it will naturally flow to other kinds of business establishments. Department stores can expect to reverse such a trend only by expanding their merchandise offerings in lines of goods not now ordinarily sold in such stores. Even if that cannot be done, they can expect a larger and larger absolute volume of business if they can only maintain their share of the present market for department store types of merchandise.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   a) department store
   b) departmentized specialty store
   c) "department store market"
   d) ownership group
   e) markdowns
   f) original markup
   g) leased department
   h) basement store division
2. How important are department stores? Answer by citing several quantitative and several qualitative considerations.
3. List and briefly explain each of the competitive advantages and disadvantages of department stores. To what extent are these unique among department stores and to what extent are these associated with large-scale retailing in general?
4. When did department stores become significant institutions in the United States? What historical changes in the economy were related to the development and early growth of such stores?
5. How have changes in income distribution affected some department stores more favorably than others? Explain.
6. How does the composition of the sales volume of smaller department stores differ from those in the largest sales volume class?
7. Explain why the management of most department stores feels that it is necessary for their merchandising executives to strive for original markups of about 40 per cent of retail or selling prices.
8. Department store sales volume in the post-World War II era has been a smaller per cent of total retail store sales than in the pre-World War II period. How is this explained?

9. In a certain midwestern city there is an independent department store with about $6,000,000 of annual sales volume. In the same city, there is the headquarters office of a regional food chain with 18 supermarkets and about $40,000,000 annual volume. Which of these organizations has the greatest buying power? Explain.
10. Distinguish three different types of multi-unit operations in the department store field.
11. Why are basement store divisions commonly found only in medium-sized and larger department stores and not in smaller stores of this type?
12. What is the outlook for department stores?
13. "A department store is merely an enlarged and departmentized or glorified general store." Do you agree? Discuss.
14. Examine the three most recent yearly reports of the Harvard Bureau of Business Research on Department Store Operating Results. Is there any relationship between size of store and operating expenses? Percentage of credit sales? Sales returns? Explain your findings.
15. If you were asked to count all department stores in the United States, what specific characteristics would you stipulate as essential to an institution before it would be included in your tabulations?
16. The Acme Department Store has just moved into its new and more spacious building. The store sells merchandise of higher price lines to a rather wealthy clientele. Proper service and atmosphere are given careful attention. For three new departments—auto accessory, music, and optical—there are persons who wish to lease them. The Acme store officials are almost certain that operation of these departments by the store will prove unprofitable because the management is inexperienced in these fields of merchandising. Also, the volume of business expected in these departments does not seem to warrant the expense which the store must incur. The company has decided, however, to disregard the lease offers and to operate these new departments even though it must do so at a loss. How can the store justify this action to its stockholders?
17. For twenty-five years the department store of which you are president has been handling X Washing Machines as an item in the regular household goods department. Sales have always been sufficient to yield a profit that justified handling the product. This morning the sales manager of the Y Washing Machine Company called on you, suggesting that you permit them to sell their product in your store on a leased department basis. What are the various points you must consider to make and support your decision? Discuss each briefly.

10

CHAIN STORES AND VOLUNTARY CHAINS

Despite the abundant literature on the subject and the numerous discussions generated since the late 1920's, there has been no clear-cut definition of the terms chain, chain store, chain system, or chain organization that would be acceptable to all concerned or even to leading government agencies dealing with data on chain stores. Common usage seems to confine the term *chain* or *chain store* to retail operations and disregards the existence of many chains of public utilities, banks, hotels, restaurants, motion picture theatres, sales and personal finance offices, and of other types some of which are an integral part of marketing as defined in this book.

Certainly it is true that most of the best known so-called *retail* chains also operate chains of warehouses for the performance of the wholesaling functions. It is therefore important that one first get an overview glimpse of chain store organizations before delving into any discussion of the retailing operations of such systems, advantages, limitations, problems, and other phases of the subject. It is also important to bear in mind that in this chapter principal consideration is given to the chain store as a retailing institution, and that the wholesaling functions performed by chain store warehouses or by chains of wholesale establishments operated without reference to owned retailing units will be discussed as part of wholesaling in a subsequent chapter.

Definition of a Chain. In order that chains or chain stores may be clearly differentiated from other types of marketing institutions, it is necessary to consider certain basic factors which distinguish the chain type of organization from other types which may, in some respects, resemble chains. Among the most important of these factors are: (1) the number of establishments,

(2) the type of merchandise handled, (3) the plane or level of operation, (4) ownership of the units in the organization, and (5) management control. On the basis of these factors, *a chain or chain store system or organization may be said to consist of two or more centrally owned units, handling, on the same plane of distribution, substantially similar lines of merchandise.* This definition is in line with that used by the Federal Trade Commission in its reports on the chain store investigation which it conducted over a period of several years beginning with 1928. It is also in accord with the definition used in the Census of Business for the purpose of classifying retail stores. While avoiding use of the term "chain," the Census considers a store as a member of a *multi-unit* organization "if it is one of two or more stores in the same general kind of business operated by the same firm." Thus, according to this basis, a firm is classified as "multi-unit" if it operates two or more stores in the food group, or in the apparel group, or in the furniture and home furnishings group, or in some other similar classification; but a firm operating one drugstore, a hardware store, and a furniture store would not be so classified, and all the individual stores in this case would be regarded as single units.

From these definitions it is clear that emphasis is placed on central ownership rather than management control, and to that extent at least, chains are to be distinguished from the so-called cooperative or voluntary chains in which the retailer members preserve individual ownership of the stores which they operate. The implications of this distinction are extremely significant. The central organization of a regular chain has full control over its retail units, assumes full financial responsibility for such units, bears all loss when a unit is closed and retains all profit made by each store, and supplies all initial and operating capital for the unit. In a voluntary chain, on the other hand, cooperation with the central organization is voluntary and contractual; the individual store assumes full financial responsibility for its acts; all profit earned by the store is retained by its owner; when a store is forced to close its doors it is considered commercially and legally a failure and the total loss is borne by the owner and his creditors and none of it is shared by the other members of the voluntary chain; and all capital for the store must be supplied by its owner and creditors.

Classes of Chains. Two of the most important ways of classifying chain store organizations are according to the extent of the market area served and according to the degree to which the organization has integrated retailing with other kinds of business activities.

Geographic Basis. In terms of radius of operation, chains are generally classified as local, sectional, and national. Substantially all of the stores in *local chains* are located in or near the same metropolitan area. In almost

all major cities, there are to be found local multi-unit organizations in the food and drug fields. Such organizations are also rather common among variety stores, clothing stores, furniture and appliance establishments, gasoline service stations, and liquor stores. Department stores with a number of branches in the same trading area are another example.

Chains are classified as *sectional* if their stores are located in some one major part of the country, such as New England, the Pacific Coast states, the Gulf Southwest, or any other recognized broad geographic division. Many of these are very large in terms of number of establishments and annual sales volume and are often as well known to consumers within their area of operation as are the still larger national organizations.

The interests of *national* chains are much broader than any one section of the country. It does not necessarily mean that they cover the entire country. Illustrative are the stores operated by the Great Atlantic & Pacific Tea Co.; Sears, Roebuck and Co.; Safeway Stores Company; J. C. Penney Company; The Kroger Company; and F. W. Woolworth Company.

Integration. Another useful classification of chains is that based upon the kinds of functions performed, or the degree to which vertical integration has taken place within the organization. One group consists of retail chains *without wholesale distribution or manufacturing facilities.* Chains in this group confine their activities to the performance of retailing functions. They purchase from wholesalers, just as do smaller independent merchants, or from manufacturers, similar to the practice of department and many specialty stores, without maintaining a distinct wholesale warehouse. In this group belong many of the local chains of only a limited number of store units, also a substantial number of the larger organizations operating in the shoe, millinery, and apparel fields.

A second group consists of chains *with warehouses or wholesale distribution centers.* This is typical in all convenience goods lines where regular wholesalers are of importance in serving independent merchants. As such chains grow in size and circumvent the wholesaler, they almost invariably find it necessary to provide somewhat comparable physical facilities in which wholesaling activities are performed for the organization. In fact, there is no stronger evidence of the universal and indispensable nature of the functions of the wholesaler than the very existence of chain store wholesale warehouses. While some of the chain store warehouses sell limited quantities of merchandise to outside retail organizations, they are operated mainly for the purposes of effecting the distribution of goods to the retail units of the chains.

The third type consists of chains that have integrated still farther by *the performance of manufacturing activities.* This group overlaps with the second in that its members ordinarily also operate wholesale distribution centers

in addition to manufacturing establishments. The practice of actually operating factories or controlling their operations by furnishing manufacturing specifications and taking all or a substantial part of their output is common among the mail order companies that also operate large numbers of retail stores. The Kroger Company and the Great Atlantic & Pacific Tea Co. are illustrative of organizations in the food field that engage in manufacturing, processing, or canning operations to a considerable extent. In other lines of business, the backward integration of the Shoe Corporation of America is illustrative. Sometimes integration has taken place *forward* from manufacturing toward retailing, rather than *backward* from retailing toward manufacturing. Illustrative is the practice of certain major oil-producing companies whose principal business is done through bulk tank stations but which also operate some retail filling stations. Another field in which this is common is shoe manufacturing. Several large shoe manufacturers have acquired chains of stores and operate them as controlled outlets. A well-known example is the General Shoe Corp., one of the nation's biggest shoe manufacturing firms. The company has a subsidiary, General Retail Corp., which operates about twenty separately designated chains of retail shoe stores and leased departments, including those identified to the public as Jarman, Douglas, Flagg Brothers, Hardy, Holiday, I. Miller, Delman, and Nisley. Other examples are to be found in the men's clothing field, particularly the stores operated by the Bond Clothing Co. and by Richman Bros. Co.

It is thus apparent that to regard chains as purely retailing institutions is erroneous. Almost all of the medium-sized and larger organizations possess most of the characteristics of both retailing and wholesaling enterprises, and many are manufacturing as well as merchandising concerns.

Origin and Development of Retail Chains.[1] The chain store of the modern type, like the mail order house and the department store, is of comparatively recent origin. The chain idea of distribution, however, has many forerunners and prototypes. As early as 200 B.C., a certain Chinese businessman owned a chain of a great many units. A poster found in Pompeii, destroyed in A.D. 79, advertised for lease a certain property consisting of 900 retail shops.[2] The Mitsui system of apothecary shops in Japan dates from 1643, and the company has been one of the wealthiest and most powerful businesses in that country.[3] In the Americas, the Hudson's Bay Company op-

[1] For a more detailed account, see Godfrey M. Lebhar, *Chain Stores in America* (New York: Chain Store Publishing Corporation, 1952).

[2] P. H. Nystrom, "Retail Trade," *Encyclopaedia of the Social Sciences* (New York: The Macmillan Co., 1934), Vol. XIII, p. 350.

[3] J. E. Orchard, "Mitsui," *Encyclopaedia of the Social Sciences* (New York: The Macmillan Co., 1933), Vol. X, p. 550.

erated a chain of trading posts prior to 1750. But in the United States the development of the modern chain was not started until the Great Atlantic & Pacific Tea Company was founded in 1858, although the second store was not opened until a year later. The second of existing chains is Park & Tilford, which began business in 1840 but did not open a second store until 1860. The Jones Brothers Tea Company came into being in 1872, and the F. W. Woolworth Company proved the validity of the chain principle in the variety business about 1880.

While a number of chains were established during the latter half of the nineteenth century, their real growth occurred during the present century. It is estimated that in 1900 there were but 700 chains with 4,500 stores. Each succeeding year showed an increase both in the number of chains and in chain units. At first the number of chain systems grew faster than the multiplication in store units, but the reverse was true during the latter half of the period, indicating a possible absorption of the smaller chains by the larger ones and a development of large chain systems on an ever-increasing scale.

The growth in chain store volume of sales was spectacular. As late as 1919 the estimated volume of business done by chains was less than 5 per cent of total retail sales, but by 1929 this proportion had increased sixfold to about 30 per cent. The almost phenomenal development of chain organizations during the 1920's is explained by economic and social factors. The time was ripe to apply mass methods on a more widespread basis in the field of retail distribution in which efficiency had not generally kept pace with the mass production techniques used in industry. The number of people living in cities was about twice that at the beginning of the century, with a large amount of the city growth coming during the 1920's. City locations are particularly desirable from the standpoint of chain store organizations, for the cost of advertising, supervision, and distribution from wholesale warehouses is low when units are highly concentrated. The development of the automobile and the improvement of roads made it possible for those in rural areas to visit cities for purposes of shopping more frequently. Between 1914 and 1920 retail prices almost doubled, with the result that most consumers became extremely price conscious. Because of certain operating economies that were effected, in part by a transfer of marketing functions to consumers, and because the chains were able to purchase merchandise on very favorable terms in a prevailing buyers' market, they were advantageously situated with respect to underselling independents. It is doubtful if there was any period in our previous history when price appeals were any more in harmony with the buying motives of the great mass of consumers.

Later Developments and Current Status of Chains. The number of retail store units and sales volume importance of chains in recent decades is indicated by the following data:[4]

Census of Business Year	*Number of Stores in Multi-unit Firms*	*% of Total Sales of All Retail Stores*
1929	216,524	29.6%
1939	201,040	30.6
1948	162,655	29.6
1954	167,027	30.1

From the standpoint of number of stores, chains had reached a saturation point by 1929, followed by a decline until after 1948 when the downward trend was halted and somewhat reversed. The volume of business transacted is, however, a much more important criterion of relative significance and this tells an altogether different story. Throughout the entire period covered by the foregoing data, chain store sales have been approximately stable at about 30 per cent of the total sales volume of all retail stores. Thus, chains have kept pace with nationwide growth in the volume of total retail sales, but have not fared any better than this.

The decline in the number of units operated by chains at the same time that total sales have increased in amount may be explained by several factors. One was the policy in the grocery business of operating complete food stores. For some time prior to 1929 there was a tendency for grocery stores to add meats and fruits and vegetables to their stock and thus become what has been termed combination grocery stores. This trend was greatly accelerated after 1929. A second reason has been the need for grocery chains to meet the competition of supermarkets which developed in the early 1930's, by operating fewer but larger units. Third, during the 1930's many oil refineries adopted a policy of turning over the operation of company-owned stations to independent merchants. Fourth, all of these trends and policies have been stimulated and encouraged by the growth of chain store taxation. In some fields of retailing, however, the number of retail units operated by chains actually increased during the period under consideration. As experience proved their worth, the number of such stores was increased in the retailing of shoes, hats, and other kinds of business.

Important Variations in Chain Store Sales Volume. Summary data for the United States as a whole do not tell the whole story of the importance of chain store sales. Such sales have varied in importance with business conditions, by lines of trade, and in metropolitan areas as opposed to the country as a whole. Furthermore, an appraisal of chain store importance must take into account the relative status of chain organizations of different sizes.

[4] See Table 12 in Chapter 7 for source and notes regarding comparability of the data.

Cyclical Variations. A careful study of chain store operations since 1929 suggests certain conclusions that might justifiably be drawn from such experience. One is that during periods of depression chains tend to grow in relative importance, by losing less proportionately. For example, from 1929, a quite prosperous year, to 1933, the most serious depression year in our modern history, total sales of all retail stores declined 49 per cent. In the same period, sales of independents decreased by 53.2 per cent, whereas the decline in sales volume experienced by chain organizations was only 35.8 per cent.[5] Two reasons explain this tendency. First, chains are of great importance in the merchandising of necessities and staple items, the demand for which does not decline so rapidly under adverse business conditions. Second, the price appeal which is so characteristic of chain store operations is of greater significance to consumers in times of depression.

The converse of this situation is true under more prosperous conditions. During the upswing of the business cycle chains have lost somewhat in relative importance because, first, more emphasis is placed on goods in the luxury and semi-luxury classes, and second, the price appeal loses much of its strength and gives way to the tendency to buy higher-priced or better quality goods than are normally handled by chains and to the willingness of consumers to pay for full service.

Chain Store Sales by Lines of Business. While chains account for about 30 per cent of total store sales, there is considerable variation in their importance in different lines of business. In a small number of lines, multi-unit organizations are the dominant form of retail enterprise, in others their importance is not greatly different than it is for all lines of business, and in still others they are of almost negligible significance. As shown by the data in Table 15, chains account for more than 80 per cent of the business in the variety store trade, about 77 per cent of the department store business, and about 56 per cent of the business done by shoe stores. Other lines in which chains account for more than 40 per cent of the sales volume are grocery stores, women's clothing stores, tire, battery, and accessory stores, and apparel and accessories stores. Chains account for less than 10 per cent of the business done by motor vehicle dealers, farm equipment dealers, and florists; and they do less than 20 per cent of the total among gasoline service stations, eating and drinking places, cigar stores and stands, hardware stores, sporting goods stores, and camera and photographic supply stores. It is noteworthy that the lines in which chains are of least significance are predominantly those in which service is of particular importance.

Chain Store Sales in Large Cities. Chains are generally reputed to be of greater relative importance in large cities and their surrounding metropolitan

[5] U. S. Dept. of Commerce, *Census of Business, Retail Distribution—1933, Chains and Independents and Other Types of Operation* (Washington, D. C.: Government Printing Office [no date]), p. 1-A.

TABLE 15

CHAIN STORE SALES AS PERCENTAGES OF TOTAL RETAIL STORE SALES, SELECTED KINDS OF BUSINESS—UNITED STATES: 1954
(Sales of all firms operating two or more stores in the same general kind of business)

Kind of Business	Per Cent of Total Sales of All Retail Stores in Given Kind of Business
U. S. Total, all kinds of business	30.1
Variety stores	82.9
Department stores	76.5
Shoe stores	56.4
Grocery stores	48.2
Women's clothing and specialty	43.5
Tire, battery, accessory dealers	42.4
Apparel and accessories stores	41.4
Dry goods and general merchandise stores	36.2
Liquor stores	33.9
Feed, farm, garden supply stores	29.4
Drug stores	26.9
Music stores	25.2
Household appliance, radio, TV stores	25.0
Lumber yards, building material dealers	24.1
Jewelry stores	23.8
Furniture and home furnishings stores	21.5
Plumbing, paint, electrical stores	21.1
Cigar stores and stands	19.2
Hardware stores	18.6
Book, stationery stores	17.7
Camera, photographic supply stores	15.9
Gasoline service stations	12.6
Eating and drinking places	12.1
Sporting goods, bicycle stores	11.3
Farm equipment dealers	9.5
Florists	8.2
Passenger car dealers	5.1

Source: *U. S. Census of Business—1954, Retail Trade, Single Units and Multi-units* (Washington, D.C.: Government Printing Office, 1956), Bulletin R-2-4, Table 4A.

areas than in smaller cities and rural areas. During the early period of development chains tended to concentrate in urban communities and in the most populated sections of the country. As expansion progressed they tended to invade any community where the necessary volume could be obtained. As the larger type of chain grocery operation became the mode, the smaller stores in the less populated communities were no longer profitable.

That chains are generally more important in large cities and their surrounding territory than for the country as a whole is evidenced by the census data for 14 metropolitan areas with populations of more than 1,000,000. In

these areas, the ratio of chain to total retail store sales is about 20 per cent higher than for the entire country.

Importance of Large and Small Chains. Multi-unit retailers with only two or three stores generally regard their own interests as more closely identified with those of independents, and for the most part, the competitive situation and method of store operation for this group is more akin to the independent store operation than to the systems of stores generally recognized by the public as chains. As shown in Table 16, about 37 per cent of

TABLE 16

NUMBER OF STORES AND SALES VOLUME OF CHAINS, BY SIZE OF ORGANIZATION—UNITED STATES: 1954

	Stores		Sales Volume	
Number of Stores in Company	Number	Per Cent of Total	Amount (thousands)	Per Cent of Total
Total, all multi-units	167,027	100.0%	$51,187.317	100.0%
2-3 stores	61,888	37.1	10,889,798	21.3
4-5 stores	10,870	6.5	2,847,303	5.5
6-10 stores	10,938	6.5	3,576,458	7.0
11-25 stores	14,199	8.5	5,591,158	10.9
26-50 stores	12,652	7.6	3,415,834	6.7
51-100 stores	12,239	7.3	3,464,199	6.8
101 or more stores	44,241	26.5	21,402,567	41.8

Source: *U. S. Census of Business—1954, Retail Trade, Single Units and Multi-units* (Washington, D.C.: Government Printing Office, 1956), Bulletin No. R-2-4, Table 4A.

all chain stores in the country are in this class of two- or three-unit firms. Like single-unit independents, they are smaller in sales volume size than the remainder of the chain store field. This is evident from the fact that they account for only about 21 per cent of the total chain store volume.

There is no question but that the most significant group of chains are the large organizations, i.e., firms with more than 100 stores. While this group comprises only slightly more than one-fourth of the total chain store units in the country, most of the individual units have been well located, are soundly merchandised, and do a much larger than average volume of sales per store. In spite of representing only 26.5 per cent of the units, this group accounts for nearly 42 per cent of the total business done by chain stores.

Between the small and the very large organizations are chain store firms of all intermediate sizes, ranging from 4 to 100 units. This group includes many of local and sectional chains and most of the department store ownership groups. In total, about 37 per cent of chain store sales volume is done by firms with 4 to 100 units each.

Competitive Position of Large, Centrally Managed Chains

Since there are some chain store organizations in almost every kind of business and since almost every method of store operation or merchandising technique is employed within this broad field, there are probably no competitive advantages or disadvantages common to *all* multi-unit organizations in the nation. There are, however, certain favorable competitive circumstances which are so widespread among large, centrally managed chains that they may be deemed characteristic of this segment of retail trade.

Advantages. Most chain store advantages are basically the same as those inherent in other forms of large-scale retailing. Some of these advantages of scale nevertheless take on a distinctive form within the chain store field, and there are some others that are peculiar to multi-unit organizations.

Buying Power. By combining the merchandising requirements of a number of retail units and channeling it through a central office that conducts negotiations with resources, the large chain store organization is able to buy on more favorable terms than is the single-unit store in the same line of business. Since the manufacturer's selling expenses are relatively low when disposing of large quantities to one customer, the chain is able to obtain the lowest prices on the goods it purchases and to secure other allowances related to quantity buying as, for example, advertising funds, and compensation for store displays.

While this advantage is important to the chains, it can be overemphasized. Ability to obtain lower net prices is significant only when comparing such prices with the prices paid by a competitor who performs similar functions in the channel of distribution. There is no question but that chains generally pay lower prices than independent retailers. However, most chains are integrated, at least to some extent, and must incur costs in performing wholesaling activities. It is more meaningful, therefore, to compare the prices paid by chains with those ordinarily paid by wholesalers that serve independent merchants. It is known that most large wholesalers operate on such a scale that they are able to take advantage of the maximum quantity discounts offered by well-known manufacturers selling branded goods. The chain's advantage of buying power may result in prices slightly more favorable than those paid by some wholesalers, but as a practical matter it is largely confined to situations where manufacturers are small, do not have a uniform price schedule, and produce merchandise to the chain's specifications without offering exactly comparable merchandise to wholesalers at any price. There is no doubt that the larger chains have significant advantages in instances where they are able to contract for all or very substantial portions

of the output of particular manufacturers—something that cannot very well be done by the typical independent wholesaler.

Buying Skill. Large chains also have the benefit of considerable *buying skill,* a natural result of the division of labor to be found in chain organizations. At the central or district headquarters organizations are to be found merchandising experts who spend all of their time maintaining market contacts, collecting and interpreting marketing information, viewing offerings of vendors, determining the suitability of merchandise for sale by the company, and conducting negotiations. Unlike the manager of the independent store, the chain store buyer specializes in a very narrow range of merchandise and becomes thoroughly acquainted with all of the characteristics of the producing industries represented by his range of merchandise specialization. Unlike the buyer in the large department store organization, the chain buyer spends practically all of his time in the performance of the buying function; he does not have the problems of managing a retail department, preparing advertising, supervising salespeople, and other similar activities that claim most of the working time of the department manager in the large independent department store. Here, too, the chain's advantage is largely dissipated when compared with the wholesaler's buying organization and skill, which is really on a more comparable level.

Low Operating Costs. Certain economies, attributable to characteristic practices among large chains, result in relatively low operating costs within such organizations. One of the most significant economies among chains with warehouses is derived from the *integration of wholesaling with retailing.* A better coordination between these functions is secured, stores are supplied with all their requirements from or through a single chain store warehouse, no salesmen need call upon the managers of the stores to solicit business, credit problems are eliminated, and deliveries can be effectively scheduled. On the other hand, chain store home office and district executives must supply more supervision and assistance than is normally given by independent wholesalers. It is believed that chain store warehouses can save from one-fourth to about one-half the margin of the wholesaler, provided of course that the chain is satisfied with a single profit and is willing to perform the wholesaling functions at cost. It is also assumed that the chain does not shift many of the wholesaling functions back to the manufacturer, an assumption which is frequently not justified.

A second economy is a *curtailment of services* to the consumer. While there are some exceptions, chains generally are more limited-service institutions than are independent merchants. They usually sell only for cash, thereby eliminating costs of maintaining credit departments. Instalment credit is common among chains in the durable goods lines and even among

some of the soft goods lines; but a charge is often made for this form of credit and it is therefore often a source of additional income, rather than an out-of-pocket cost to be recovered from retail prices. Delivery service is not common for any of the convenience goods chains. Among chains in shopping districts, customers may have parcels delivered; but this is usually accomplished through some form of a consolidated merchants' delivery system and a charge is often made. In the grocery trade, self-service operations are much more characteristic of chains than of independents. All these service limitations, while making possible operating economies, may be viewed in another light, namely, that they represent successful attempts to shift the performance of some of the marketing functions to the consumer.

Many chains secure economies by *limiting the composition of their stocks.* By concentrating offerings on those items for which there is a widespread and ready demand, higher than typical rates of stock turnover are attained. As long as this can be accomplished without sacrificing an organization's ability to buy on favorable terms or without risking loss of business on account of out-of-stock conditions, several advantages are realized. These include less risk due to merchandise deterioration or style obsolescence, less storage space required per unit of sales, lower capital costs for merchandise inventories, and lower insurance costs on inventories.

Price Appeal. Low merchandise costs stemming from large purchasing power and the relatively low operating costs of chains, when combined with a prevalent chain store philosophy that a small percentage of net profit will maximize sales and yield large *total* dollar profits, results in a third important advantage, that of the ability to feature *price appeal.* The extent to which chains *actually undersell* independent competitors has been a matter of controversy for so many years that numerous attempts have been made to carry on studies and conduct surveys that would throw needed light on this question. With but two or three exceptions, such studies concerned themselves with grocery store prices and were limited to a single community. In practically all cases the comparison was limited to identical items handled both by chain stores and by independents. A further limitation is to be found in the statistical techniques employed, which in many instances were found wanting.

Despite the limitations just indicated, the conclusion from these studies is that, in general, chain stores undersell full-service independents.[6] This

[6] Some significant studies related to this question include the following: Ralph H. Oakes, "Price Differences for Identical Items in Chain, Voluntary Group, and Independent Grocery Stores," *The Journal of Marketing,* October, 1949, pp. 434–36; T. N. Beckman and H. C. Nolen, *The Chain Store Problem* (New York: McGraw-Hill Book Co., Inc., 1938), pp. 130 ff. Other well-known studies of chain–independent price comparisons include the following: C. F. Phillips, "Chain, Voluntary Chain, and Independent Grocery Store Prices," *Journal of Business of the University of Chicago,* Vol. XII, No. 1 (1939), p. 26; P. D. Converse, "Prices and Services of

does not mean that *all* chains undersell *all* independents. Many independent merchants sell at the same, or sometimes at a lower, price level. But chains as a class have an advantage when a direct price comparison is made with independents as a class, insofar as prices are concerned. Yet, many voluntary chains in the grocery business meet the prices of chains, and the same is true of automobile accessories and in variety stores. Independent grocers who have adopted self-service methods have found that the saving effected from a reduction or elimination of sales services, credit, and delivery enable them to attain operating costs sufficiently near to those common to chains to meet their price competition. If in the future consumer demand or reaction indicates the wisdom of returning to a full or partial service policy, costs will necessarily increase. Under such circumstances the independent merchant rendering services cannot be expected to meet the prices charged by nonservice chain units.

The implication is that all stores do not give the consumer the same satisfactions, even when the same goods are involved, so long as the services in connection with those goods are different. For that reason, the comparisons of prices charged by independents and chains, respectively, are not truly valid and scientific unless account is taken of differences in services. Only in that way can net social gains resulting from the price differentials be measured. Another problem relates to price differentials on privately branded goods and on merchandise which is not identical in character. On this point there is considerable controversy. Independents claim that on such goods, on which comparison by consumers cannot be made, higher prices are charged by chains as a class than by independents as a class. Some of the chain operators, on the other hand, claim that even greater savings are passed on to consumers on such merchandise.

One must not infer from this discussion that alleged or real lower prices are the only attractions offered to consumers by chains Other motives such as convenience of store location, quality of merchandise, personality of the store manager and other employees, and advertising have been frequently cited by consumers in studies designed to ascertain reasons for patronizing chains. Although many chains carry limited stocks because of the scientific selection of items, many consumers have the impression that wide assortments are carried. From this it would seem that neither chains nor independents have a monopoly on any one patronage appeal and that probably a combination of motives operates in attracting a consumer regularly to a given store, whether chain or independent.

Chain and Independent Grocery Stores in Champaign-Urbana," *The Journal of Marketing*, July, 1938, p. 195; Ralph Cassady, Jr., and E. T. Grether, "Locality Price Differentials in the Western Grocery Trade," *Harvard Business Review*, Vol. XXI, No. 2 (1943), p. 199.

Advertising Advantages. Where chain stores are in competition with neighborhood unit stores, they have marked advertising advantages. For example, a grocery chain organization with retail units located in all sections of a city can afford to use newspaper advertising space or the radio. Neighborhood unit stores, with their localized markets, cannot afford to do newspaper advertising or to broadcast over the radio, since their places of business would be relatively inaccessible to most readers or listeners. Where voluntary chains have been formed, independent grocers have combined their efforts and used newspaper advertising space, the radio, or other media, to promote the sales of items stocked by all members of a given group. In the main, however, the chain store occupies a preferred position with reference to local advertising.

Experimentation in Merchandising. Chains operating a considerable number of retail units can often undertake experiments which could not be made without great risk by their competitors. For example, lines of merchandise can be added to or dropped from the stock at one retail unit, and the results can be used in formulating the practices and policies of all of the stores. Similar experiments can be made with respect to services, displays, stock arrangement, store layout, and other matters. The independent competitor, operating a single retail unit, must make such experiment at great risk because resulting losses cannot be supported as in the case of the chain by profitable operations in other stores.

Risk Distribution and Competitive Superiority. The wide territorial distribution of the retail units of many chains reduces their risks, since a lack of local prosperity and a decline in sales or profits in one store may be offset by corresponding profits in another section and in other stores. This same width of their market enables chain stores to transfer slow-moving stocks from some of their stores to units in which the demand for such goods is very much greater.

By varying prices charged to consumers, not only within the same city but between different cities and sections of the country, the chain is able to average its profits and at the same time meet whatever competition may arise locally. This is an advantage which the voluntary chains cannot imitate, for a price war in the latter instance affects the total business of a retailer member which cannot be offset, as in the case of chains, by the profits earned in the other stores of the group.

Competitive Limitations. As in the case of the favorable factors discussed above, there are no single disadvantages that apply to each and every chain store organization in every line of trade. There are, however, a number of unfavorable factors that exert a restrictive influence upon large, centrally managed chain store companies as a whole.

Standardization of Operating Procedures. While the standardization of merchandising and operating policies and procedures is a feature which makes it possible for the management of a large chain to operate it from a central or regional headquarters office, it is also a factor which has limited chain store development in certain fields where individualized management attention is of unusual importance. Large national chains are nonexistent in the hardware trade, for example, presumably because of the great diversity of items which must be handled and the minute supervision and care necessary to maintain balanced stocks. Carelessness on the part of the local manager may result in a serious lack of necessary items or in excessive inventories of unsalable or slow-moving stocks. Further difficulties are found in the multiple price system which prevails in the sale of such lines as builders' hardware. In many communities competitive conditions result in price concessions to builders, the price reductions granted varying roughly with the volume of purchases and the bargaining power of buyer and seller. The situation is further complicated by the frequent absence of any definite schedule of prices. Under such circumstances chains find it particularly difficult to operate, since they may be unwilling or may find it impossible to entrust such responsibilities to local managers. In any trade in which contract work appears, chains are at a disadvantage, not only because each contract offers a particularized pricing problem but because problems of outside sales promotion and installation introduce some complications.

Limited Service. The common practice of eliminating services such as credit and delivery and the limitation of stocks to articles in large demand, while reducing expenses of operation and increasing the effectiveness of their price appeal, limits the scope of chain operations to those consumers who are willing to dispense with these facilities. There still are and are likely to be large numbers of consumers who insist upon and are willing to pay for the services and facilities which independent stores offer.

Limited service is not necessarily a policy inherent in chain store operation. It is possible for chains to give such common services as delivery and credit. In fact, certain variety chains are even now making deliveries, accepting telephone orders, and in a few cases granting credit, at least of the instalment type. Credit jewelry and clothing stores are so common as to indicate that credit, at least on the instalment basis, can be successfully granted by chains. However, in most lines of merchandise the individual proprietor who uses careful and tested credit-granting procedures probably has some advantage over the chain type of management which is not commonly adapted to individual modifications of customer relationships such as is called for in the granting of credit.

Personnel Limitations. Like other large-scale retailers, chains suffer disadvantages in the lack of personal contact between their management

and the public. It is probable that problems of personnel constitute the major obstacle to chain store growth, and that the outstanding advantage of the unit store lies in the contacts between the proprietor and his customers. Chain stores are attempting to meet these difficulties by the careful selection of employees, and by well-organized training systems. Most organizations stimulate their store managers by plans which make the manager's income dependent upon such factors as the sales or the net profit of the store under his control.

Public Opinion and the Chains. Particularly during the 1920's and 1930's and, to some extent, continuing until the present time, there have been many attempts to limit the growth of chains by arousing consumer sentiment against them. Led by some so-called representative organizations of independents and by a few individuals who perhaps saw an opportunity to further their own interests, many statements were made in the public press, over the radio, and in public meetings which were designed to induce the public to patronize independent merchants rather than chain stores.

Arguments were presented to the effect that the independent merchant, who lives and does business in the home city, deserves patronage rather than the customarily "foreign-owned" chain. It was alleged that chains take money out of town, fail to patronize local business, pay low wages, destroy opportunities for young men to enter business for themselves, do not bear their share of the local tax burden, destroy small business, tend to produce a nation of clerks, and tend toward monopoly. Attacks were made on certain alleged unethical practices of chains. It was claimed that they resort to unfair practices in order to drive local merchants out of business, that they do not actually undersell since the high prices charged for their private brands or for unidentified merchandise more than offset the amount lost through the sale of leaders, and that they exert pressure on manufacturers to sell at prices that are too low and hence higher prices must be charged by them when selling to wholesalers and to independent retailers.

Some of the allegations cited are obviously unfounded. All of them have nevertheless influenced public opinion to some degree and probably contributed to the passage of chain store tax laws and to other legal limitations. To some extent they have also doubtless contributed a measure of support to governmental policies that favor private enterprise of the small, local business firm type, as witnessed by the creation of the U. S. Small Business Administration in 1953, which was discussed in Chapter 8. It is not likely, however, that such pressures upon public opinion have seriously affected chain store patronage in an adverse manner. While some consumers do give independent merchants the preference, the vast majority patronize retail stores for reasons that are not usually affected by arguments of this kind.

Legal Limitations—Chain Store Tax Laws. Most of the legal limitations discussed in Chapter 8, in connection with large-scale retailing, were originally enacted as an aspect of the anti-chain store movement of the late 1920's and the 1930's. The chain's ability to induce discriminatory advantages in purchasing was limited by the Robinson-Patman Act, and its freedom to engage in loss-leader pricing was curtailed to some extent by the state pricing legislation discussed at that point.

In addition, many states have taxed chain store organizations in some special manner, with the intent, at least in part, of restricting the growth of chains and the multiplication of chain store units. The Indiana law, which was approved by the Supreme Court of the United States in 1931 as to constitutionality,[7] gave real impetus to the movement. In that decision chain stores were recognized for the first time as differing sufficiently from other types of retailing to justify a separate classification for license or occupation tax purposes. A classification for graduated license fees according to the number of stores in the state was thus held to be a valid classification based on substantial differences.

In all cases the tax is levied only upon the stores operated in the state in question, but the *rate of tax* may be determined by the number of stores in the state or by the number of stores wherever located. The first and most common method is illustrated by the Indiana law in which taxes or license fees are imposed in accordance with the following schedule:

Number of Stores in the Same Company Located Within the State	*License Fee per Store*
1st	$ 3
2d to 5th, inclusive	10
6th to 10th, inclusive	20
11th to 20th, inclusive	30
21st and succeeding	150

Louisiana and several other states departed from this principle and based the *rate* of fee on the number of stores *wherever located* so long as they are under the same management, supervision, ownership, or control. The tax is actually paid only for such stores as are located in the state—it being merely the *rate* per store which is determined by the size of the entire chain organization. A condensation of the Louisiana rate schedule is as follows:

Size of Chain Store Organization (number of stores wherever located)	*Tax Paid for Each Store in Louisiana*
Chains of not more than 10 stores	$ 10
Chains of 11 to 35 stores	15
Chains of 36 to 50 stores	20
(Several classifications omitted)	
Chains of 401 to 500 stores	500
Chains of 501 or more stores	550

[7] *State Board of Tax Commissioners of Indiana et al. v. Jackson,* 283 U. S. 527, 21 Sup. Ct. 540.

At one time chain store tax laws were in effect in 29 states. With the passage of time, chain store organizations became regarded as better neighbors. It came to be more widely realized that chain store companies brought new business into many communities in which they located new and modern stores, that they employed local people, and that they purchased supplies and merchandise from all segments of the economy. As a consequence, many of the laws have been allowed to lapse or have been repealed. In late 1956, there were only 12 states with chain store taxes based upon graduated license fees.[8]

One effect of these laws was to discourage the multiplication of outlets in those states where the rates are fairly high. Particularly during the 1930's, many chain store organizations closed down large numbers of their marginal units. This was especially true of the national grocery chains that were operating numerous small counter-service types of establishments during that period. The laws were also partly responsible for action taken by many oil companies to divest themselves of retail units which were, in consequence, leased to independent merchants. While the laws have undoubtedly been a contributing factor in the decline that has been registered in the number of chain store units, it is very doubtful whether they have been a marked unfavorable factor with respect to chain store sales volume. One consequence has undoubtedly been more emphasis upon larger individual retail units, in line with a trend discernible even before this type of legislation became effective, so that the tax burden would be relatively small in comparison with sales volume. There is little doubt but that many of the chains have actually benefited from closing out some of their smaller stores of questionable profitableness.

Increasing Efficiency of Independents. One of the major limits to the expansion of chains is the increasing efficiency of many of their independent competitors. Independents are as a whole carrying on their business much more efficiently than was the case prior to the advent of the chains, particularly prior to 1920. This is due to at least two causes. The increased business of the chains has driven out many of the least efficient merchants. It takes more merchandising ability to stay in business today than formerly. The better independents are the ones who have survived. Hence, the general level of merchandising ability is higher. A second reason is that many independents have learned much from the chains. Such merchandising practice as the use of open display in grocery, drug, and hardware stores,

[8] The Louisiana-type law continued to prevail in Louisiana and Mississippi. The Indiana-type law was in effect in Alabama, Colorado, Indiana, Iowa, Maryland, Michigan, Montana, South Carolina, Texas, West Virginia. The highest license fee under any of these laws was that of the Texas statute, which required payment of $825 per store for companies with more than 50 stores located in Texas. For more detailed information, consult *State Tax Guide Service,* a loose-leaf service published by the Commerce Clearing House, Inc., New York.

better lighting, and better entrances and fixtures have been copied, in part at least, from chains. Superfluous brands, price lines, and sizes have all been reduced. Better display and advertising practices have been adopted, and in other ways the level of independent merchandising has been raised. All of this has been accelerated through the voluntary chain movement. This fact will make it increasingly hard for chains to displace existing independents in the future. If expansion is made it will be at the expense of the type of merchant who is too old, too indifferent, or too independent and limited in ability to learn the lessons of modern merchandising. Unfortunately, there are still many such merchants, or rather, storekeepers.

Future of the Chain Store. The chain store type of retailing had a phenomenal development in the 1920's. In this period many new chain organizations were brought into being and additional units were added to existing chains. By 1929 expansion in both the number of organizations and the number of stores had reached its peak. Previous to that period profits from chain operation had been relatively high, a fact which attracted capital and the highest grade of managerial skill. Some manufacturers, notably those of shoes, found that integration by the operation of retail stores was desirable. The development of chain store retailing has been unquestionably an outstanding feature of twentieth-century retail merchandising up to the present time.

Study of statistical evidence shows that chains have not continued since 1929 the rate of expansion which characterized their earlier development. Today fewer such organizations are in existence than a quarter of a century ago, a fact which is largely explained by mergers of smaller with larger chains. The number of store units declined from 1929 until 1948, after which it remained at about the same level. The proportion of total retail store sales made by chains has been relatively stable at about 30 per cent over a long period.

It seems to be clear that chains have reached the point of saturation in most cities and towns and that in general they are not well fitted for successful operation in certain lines of goods. On the whole, chains were developed on sound financial, legal, and merchandising principles. A considerable portion of the public has been well served by them. There is no reason to believe that this will not be true in the future. But the fact that chains with a long enough period in which to prove the validity of their methods have not been able to secure more than about 30 per cent of all retail store sales suggests that there are economic limitations to their growth. A large portion of the public still demands services which most large centrally managed chains cannot or will not give. This fact puts a very definite limit on their expansion in the future as do certain other factors which have been discussed in this chapter.

In conclusion it may be said that the chain store type of merchandising has earned its right to exist. It has many worth-while advantages, both from the standpoint of the operating company and the buying public. Certain trends which were indicated above may modify the type of merchandising carried on by the chains in the future. Independents have modified many of their practices and policies, in order to make it possible to compete with the chain on a more equitable basis. Various legal limitations together with the growing efficiency of independents, have braked the forward movement of the chains. In some fields it may even be difficult for them to maintain their present relative position in the retailing picture. At the same time all of these had the effect of largely resolving what was formerly regarded as a serious "chain store problem."

Voluntary Chains

The growth of the regular or corporate chain deeply affected the independent merchants of this country. To compete successfully with such chains, thousands of merchants were forced substantially to modify their methods of doing business. One type of change had as its purpose an increase in selling efficiency. The appearance of the stores was modernized by better lighting, fixtures, windows, and, in many cases, by adoption of the self-serve principle. Layout was arranged in such a way as to increase sales, and the effectiveness of advertising and other sales efforts was enhanced.

The other basic change was in buying policies. In order to reduce the handicap of buying for a single store at higher prices than those charged to corporate chains, many independent merchants cooperated for the purpose of combining their purchases.

Types of Voluntary Associations. Voluntary chains or cooperative associations of retailers assume a variety of specific forms. First, there are buying and advertising groups in which a small number of independent merchants combine their purchases and engage in advertising on a cooperative basis. Second, there are retailer-cooperative warehouse groups in which a number of independent merchants mutually own and buy through a common wholesaling facility. A third form consists of voluntary chains which are sponsored by a regular wholesaling organization that has assumed the initiative for cooperative action. Fourth, some of the corporate retailing chains have expanded their area of merchandising influence by licensing or franchising "associate" stores. Finally, the franchised retail outlets of certain manufacturers, who pursue an exclusive agency or selective distribution policy, often result in such a high degree of uniformity of operations on the retail level that this may be properly regarded as an aspect of the voluntary chain idea.

Pooled Buying and Advertising Groups. An early example of the change in buying policies was the development of informal buying pools. Basing their action on the assumption that buying power was the principal if not the sole advantage of the chains, certain independent merchants, primarily grocers, druggists, and hardware dealers, developed plans for informal pooling of orders. They thus succeeded in gaining certain price concessions which, when combined with pool-cars as they often were, resulted in substantial reductions in the delivered cost of the merchandise. So long as they failed to attack the problem of effective competition with chains in other than the buying area, such groups were never very significant.

Group operations of small numbers of retailers located in the same metropolitan area became very important in the 1950's when the emphasis was shifted largely to selling and promotion. Under the prevailing arrangement, several independent supermarket-type concerns cooperate in the use of a common name such as "Foodtown" or "Market Basket." By pooling their advertising budgets, they have been able to develop impressive advertising programs, rivaling those of major corporate chains. Such firms have also set high standards in store appearance and merchandising. They often maintain the same prices in all stores in the cooperating group. In contrast with the forms of voluntary chains discussed below, the initiative comes from the cooperating retailers rather than from wholesalers, but the retailers do not own or operate any wholesale establishment. They usually pool certain of their buying requirements and often enter into a form of buying contract with some large independent wholesaling organization that serves them on a special cost-of-service basis. The success enjoyed by many such groups has led one authoritative source in the food field to describe them as "one of the most important developments in metropolitan area food retailing" in 1955.[9]

Retailer-Cooperative Warehouses. Many of the early informal buying groups found that a logical step in their development was to purchase an existing wholesale house or to form a new one. In other cases, groups of merchants were organized for the express purpose of operating their own wholesale house. In either case, a paid manager and paid employees conduct the house just about as they would if it were owned by a private corporation. Stocks of goods are purchased, stored, sold, and delivered.

Credit is extended by some of the wholesale houses operated cooperatively, but often only after members have made advance cash deposits amounting to a week's or two weeks' average purchases. Even then, it is usually limited in amount to the size of the deposit. Actually this is not an extension of credit, but rather an arrangement of convenience enabling the merchant to dispense with the necessity of settling each individual

[9] "Facts in Grocery Distribution," 1955 Edition, *Progressive Grocer,* pp. 3–4.

transaction at the time it is made. Thus the risk incident to bad-debt losses is often completely eliminated and other savings in the extension of credit accommodations are made, since credit investigations and collections can be minimized.

It has been found from experience that a large group of 40 or more active merchant members is needed to maintain a retailer cooperative warehouse. With a smaller number it is difficult to secure adequate capital to start the company; quantity buying which is one of the principal objectives of the organization cannot be used effectively; cooperative advertising may prove too expensive; and advantage cannot be taken of favorable market conditions. Moreover, if a community does not have at least that many merchants interested in maintaining a cooperative, it is not large enough to warrant the necessary investment in the wholesale enterprise.

Members of retailer cooperatives are usually required to concentrate their purchases with the retailer-owned wholesale house and thus make possible the partial or total elimination of salesmen and other forms of sales effort by the wholesale house. Telephone solicitations should, in theory, be the most extreme form of selling effort needed. Since, however, members are subject to constant sales pressure from other wholesalers and are sometimes offered better prices than those quoted to nonaffiliated retailers, many purchases are made by them outside their own house. To offset this lack of patronage and to keep the members in contact with the management of the retailer-owned wholesale establishment, it has often been necessary to send out salesmen or contact men. Even then the cost of selling is less than when a corps of salesmen is employed by a privately owned wholesale house of similar size.

Wholesale houses owned by retailers, designated by the Bureau of the Census as retailer-cooperative warehouses, do not bulk large in the total wholesaling picture, as they account for substantially less than one-half of one per cent of total wholesale trade. What lends importance to this type of institution is its high concentration in a single line of business, namely, the grocery trade. In the 1954 Census of Business, 194 establishments out of a total number of 3,320 general-line grocery wholesalers were classified as retailer-cooperative warehouses, and this small group accounted for 17 per cent of the total sales volume of such general-line grocery wholesalers. In 1948, retailer cooperatives accounted for only 10 per cent of the total volume of the same group. This relative growth may be attributed in large measure to the fact that retailers belonging to such groups are, for the most part, large and progressive. Conversion to a self-service supermarket type of operation has been more common than among independent grocers in general. Aggressive cooperative advertising in many communities has also played an important role.

Census data show that retailer-owned warehouses in the grocery business incur a normal operating cost of 4.4 per cent of their sales. This compares to 8.9 per cent of sales for ordinary full-service wholesalers and 4.2 per cent of sales for cash-and-carry wholesalers. Thus, retailer-owned wholesale houses save about 4 cents per dollar of wholesale sales on the operating side over the ordinary full-service wholesaler and have about the same costs of doing business as do cash-and-carry wholesalers. This saving is achieved through the elimination or curtailment of credit, the elimination of regular salesmen, the concentration of retail store orders with one major supplier, limitation of inventories to fast-moving staples in many cases, and provision of capital by members.

While retailer-cooperative warehouses are predominantly associated with the grocery trade, some such organizations are encountered occasionally in other lines, notably drugs, hardware, and office supplies and stationery. In most such cases, the emphasis is primarily upon the presumed economies of group buying through an owned wholesaling facility. Outside the grocery trade, such organizations have made little effort to operate according to the voluntary chain principle by common store identification or group advertising.

Wholesaler-Sponsored Voluntary Chains. Many wholesalers attempted to offset declines in their sales volume incident to the growth of corporate chains by organizing groups of independent merchants who, in return for specified special services rendered to them by the sponsoring wholesaler, agree to buy all or a major part of their merchandise requirements from him. Such groups constitute what are known as *wholesaler-sponsored voluntary chains* and are designated by the Census of Business as voluntary group wholesalers. They differ from retailer-cooperatives in two ways. First, the initiative for organizing comes from the wholesaler rather than from the retailers themselves. Second, the wholesale house remains under private rather than cooperative ownership.

Although wholesaler-sponsored chains vary in many details, the essential basis of operation is similar in all cases. It is one of mutual cooperation. The retailers agree to concentrate their purchases in the hands of the sponsoring wholesaler. While not all retail prices are uniform, advertised articles must be sold at the same price in every member store. The wholesaler in turn agrees to furnish certain merchandising advice and to be alert in his search for favorable opportunities to buy merchandise, the sale of which can be promoted by the group. Moreover, because there is some degree of concentration, the buying power of the wholesaler is usually increased through the sponsorship of a voluntary chain. Resulting savings are passed on to member stores as an aid to them in meeting the competition of the corporate chain.

The quantitative position of wholesaler-sponsored voluntaries cannot be judged precisely from census data because most such wholesalers sell to nonaffiliated retailers as well as to members of the voluntary chains which they sponsor. In 1954, there were 574 establishments operated by voluntary group wholesalers in the grocery trade, and they accounted for 34 per cent of the total sales volume of all general-line grocery wholesalers, an increase from the 28 per cent reported in 1948. Operating costs of voluntary-group grocery wholesalers amount to 7.4 per cent of sales, as compared with 8.9 per cent for regular grocery wholesalers without voluntary chains. Such costs are higher than for retailer-cooperative warehouses by some 3 cents on the sales dollar because a substantial proportion of the total sales volume is made to small independent stores outside the membership of the voluntary chains, regular salesmen are used, credit accommodations are provided, and because a wider range of advertising, sales planning, and store merchandising services is customarily offered to members of the voluntaries than is received from retailer cooperative warehouses by their owners.

While wholesaler-sponsored voluntary chains have attained the highest form of development in the grocery business, it should not be inferred that they are limited to this field. Butler Brothers, the leading wholesaler of variety goods, sponsors a voluntary chain of some 2,300 Ben Franklin variety stores located in all sections of the United States. Such stores are operated under a franchise agreement which calls for a payment by the retailer of a yearly fee ranging from $180 to $750, depending on store size.[10] In return for this fee, the wholesaler provides: a complete warehouse service for all merchandise items needed to operate a variety store; a detailed stock control system; automatic store shipments of new merchandise items; a planned promotional program tied to the seasonal requirements of each month of the year; professionally prepared sales plans, display signs, price tags, and store decorations; assistance from specially trained field advisors; cooperative rebates on store purchases based on the annual volume of buying from the wholesaler; and permission to use the Ben Franklin name.

Another example of a wholesaler-sponsored voluntary consists of Rexall Drug Stores that are to be found in almost all communties. They are supplied with merchandise items from wholesale warehouses operated by the Rexall Drug Company, are identified to the public as Rexall stores by the familiar orange and blue signs of the company, and participate in a variety of special promotional events, including the nationally advertised Rexall one-cent sales.

[10] *Opportunity and Security in a Retail Business of Your Own* (Chicago: Butler Bros., 1954), p. 19.

In the restaurant field, another application of the same idea is to be found among the Howard Johnson eating places. Many of these establishments are independently owned, have a uniform appearance, and are under franchise to a central wholesaling organization which furnishes equipment, supplies, and food to the individual operators who agree to maintain uniform standards of quality and service.

Coordinated Groups of Voluntaries. Practically all wholesale grocers who operate voluntary chain groups are members of some of the dozen or more federations of such wholesalers. In order to secure certain advantages of group action such as large-scale buying and promotion of private brands, it became necessary for voluntary group wholesalers to operate jointly.

One of the best known of these central organizations is the Independent Grocers Alliance of Chicago. More than 50 wholesaler members serve about 6,000 stores in all parts of the country. It assigns a franchise to a wholesaler who in turn grants the retailer the right to display the I.G.A. sign, carry the private brands of the organization, and receive merchandising aids. The central office buys goods to be packed under the I.G.A. labels and advertises such brands nationally. Red and White Stores, Clover Farm Stores Corporation, Nationwide, and Quality Service are similar coordinated groups. In 1955, the U. S. Wholesale Grocers' Association formed a subsidiary, Food Merchants of America, which owns three voluntary group names—Shopworth, Economat, and Markrite—for use by member wholesalers in their own voluntary chains. Food Merchants of America serves as the coordinator for the wholesalers, supplying uniform accounting procedures for retail stores, advertising and display materials, and other basic merchandising tools. Within eight months of the formation of this new agency, it was reported that wholesaler members had started some 40 new voluntary chain organizations sponsored under one of these names.[11] Retailer cooperatives attain the same end through affiliation with the National Retailer-Owned Wholesale Grocers.

Voluntary Affiliates of Corporate Retail Chains. The forms of voluntary chains discussed up to this point may be viewed as defensive measures undertaken by independent merchants or their suppliers in order to compete with corporate chains more effectively. A third form of voluntary consists of a company that owns and operates a chain of retail stores and also serves as the headquarters for a similarly identified group of independent "associate" stores. When a corporate chain organization undertakes such action, its motive is not to promote competition with itself. Quite to the contrary, independent affiliates are usually selected from among merchants located in places that do not offer sufficient volume potential to be attractive from

[11] "USWGA Helps Mom-'n-Pop Groceries To Fight Chains by Forming Chains," *Business Week*, April 21, 1956, pp. 66–67.

the standpoint of chain ownership. By selling through a group of associate stores, the chain can add substantially to its purchasing power, increase the volume of business handled through its wholesaling facilities, reduce the costs or expand the extent of its advertising program, spread the costs of corporate administration over a broader sales volume base, and realize a profit on wholesale sales made to affiliated stores.

Probably the best known example is the Western Auto Supply Company which operates 18 wholesale houses, a chain of 365 completely owned retail stores located in medium-sized and large cities, and has some 3,500 affiliated independent merchants who are identified to the public as "Western Auto Associate Stores."[12] For the most part these independents are located in smaller communities, and the size of the establishment is considerably smaller on the average than that of the company-owned stores. The independents concentrate their purchases with the Western Auto wholesale houses, participate in company advertising, and benefit from the company's merchandising advice and physical assistance in store operation. Additional examples of the same method of operation in the automotive accessory business are provided by numerous independent merchants affiliated with manufacturers of tires such as the Firestone, Goodyear, and Goodrich stores. Each of these companies operates a chain of company-owned stores, performs wholesaling functions, buys and resells merchandise that it does not manufacture, and engages in voluntary chain activities with independent merchants whose stores resemble the company-owned retail outlets insofar as appearance, layout, operating policies, and advertising are concerned.

Examples in other lines of trade include the "Walgreen Agencies" which supplement the company-owned stores operated by the Walgreen Drug Company; small-town men's clothing merchants who have been licensed by the Bond Stores, Inc. to sell suits and coats merchandised in that company's chain of stores which are located, for the most part, in large cities; and independent merchants franchised to supplement the company-owned retail outlets of the Adam Hat Stores, Inc.

Franchised Retail Outlets of Manufacturers. The similarity among the operations of individual retail outlets that are franchised by certain manufacturing companies places them at least on the fringe of the voluntary chain movement. The merchandising advice and assistance provided by some of the large shoe manufacturing companies such as the Brown Shoe Company, Inc., and the various divisions of the International Shoe Company, together with the close working relationship maintained with merchants who buy substantially from one source is one good illustration. Certain paint manufacturing companies, especially those that are local or regional in character, distribute through carefully selected retail paint stores,

[12] The figures cited are as of the end of 1955 and were taken from the annual report of the company.

provide them with store signs and other store equipment, plan and carry out sales promotion programs for the whole group of such dealers, and in general function in accordance with the procedures followed by other classes of voluntary chains. Some manufacturers of men's clothing and men's furnishings enjoy similarly close working relationships with many of their dealers who are identified to the public primarily as outlets for the manufacturer's line of goods.

Strength and Weakness of the Voluntary Chain. That the voluntary chain has inherent strength is shown by the success of the plan and its apparent stability. Not all efforts or plans along this line have succeeded, but enough has been accomplished to prove that the basic principle, that of groups of merchants working together to secure buying, advertising, and merchandising advantages, is fundamentally sound. Certain basic factors seem to account for the success so far attained.

Perhaps the strongest advantage is the fact that the superior planning of the sponsoring organization has raised the level of merchandising in the member stores. Reference has been made to the establishment of physical standards of store operation. Some plans allow the sponsor to cancel the membership of any retailer who fails to keep his store in such a manner as to reflect credit upon the group as a whole. Possibility of such action stimulates indifferent merchants to greater endeavor. But the fact that this is the most drastic action which can be taken, handicaps voluntaries when their status is compared with that of a corporate chain which can remove a manager if he fails to meet the standards of the chain. The other principal advantages of the voluntary plan are, as explained above, the ability to secure better prices; advantageous discounts; and, to some degree, advertising allowances, improved displays, and other merchandising helps.

Certain weaknesses exist, however. Lack of strong central control is perhaps most important. The sponsor or a committee of the members can go only so far in encouragement or instruction in better merchandising methods. The policy of some wholesaler-sponsored voluntaries of almost forcing the retailer to concentrate on the wholesaler's private brand or on those of the coordinated group is often a weakness, for many consumers have a definite preference for nationally advertised brands. If both types of merchandise are carried, the inventory becomes unduly high.

These weaknesses are not expected to limit seriously the development of voluntary associations in the foreseeable future. As pointed out in this chapter, great sales volume increases were experienced by retailer-cooperative warehouses and wholesaler-sponsored voluntary organizations over the period 1948–1954. In 1955, it was estimated that nearly two-thirds of the total sales volume of independent grocery stores was accounted for by members of either a retailer-cooperative or a wholesaler-sponsored vol-

untary chain.[13] Substantial expansions have also been noted in the case of Ben Franklin Stores, Western Auto Stores, and related types of organizations cited in the foregoing paragraphs. It appears that the concept of voluntary association has wide application, that it has strengthened the position of independent merchants who have taken advantage of the opportunities thus offered, and that future expansion is limited almost solely by the number of qualified leaders and merchants who develop an appreciation for the benefits that such group activities may hold for them. As may have been evident from the context of this discussion, voluntary chains have developed primarily in lines of merchandise where it is feasible for merchants to utilize one principal source of supply on the wholesale level. Up to this time, little voluntary chain activity, other than group buying, has been observed in the case of fashion merchandising which involves assembling from numerous sources located in markets at quite a distance from the typical dealer.

Questions and Problems

1. Define or briefly explain each of the following terms:

   a) chain store
   b) voluntary chain
   c) vertical integration
   d) buying pool
   e) retailer-cooperative
   f) coordinated group of voluntaries

2. Why was it possible for chain store organizations to experience such a favorable expansion during the 1920's? Give several reasons.
3. Distinguish between two different kinds of buying advantages associated with large centrally managed chains.
4. What are the principal explanations for the relatively low operating cost experience of large, centrally managed chains?
5. What is the purpose and nature of state chain store tax legislation? What has been the trend in and the effect of these laws?
6. Do chains increase or decline in importance in periods of depression? Give reasons for your answer.
7. Just how important are chain stores? Express this in several pertinent ways.
8. In various studies made, it has been shown that on identical items handled by both types of stores, chain stores have generally been underselling independents. What are the two most important factors in chain store operation that makes this possible? Is the gap in these prices likely to narrow, widen, or remain the same? Explain.
9. At the present time, do large chain stores engage in any monopolistic practices which are detrimental to public welfare? Have they done so in the past? Explain.
10. If left uncontrolled, is it likely that our marketing institutions will in time fall in the hands of a few large monopolistic chain organizations? Has the

[13] "Facts in Grocery Distribution," 1956 Edition, *Progressive Grocer,* p. 16. In this study independents are defined to include small multi-unit organizations of ten stores or less.

government taken any steps to prevent this eventuality? Are there further governmental controls along this line that you would suggest? Discuss fully.

11. If the law of diminishing returns is a universal economic law, why doesn't it mean higher costs for some of our gigantic chain store organizations? Can it be that the law of diminishing returns does not apply to such enterprises?

12. How, and to what extent, are chain organizations vertically integrated? From the vantage point of marketing costs and efficiency, how does this type of vertical integration compare with the type which exists when a manufacturer sells direct to consumers through his own retail outlets?

13. Explain the differences between the several forms of voluntary chains.

14. Why would a regular retail chain store organization voluntarily sponsor independent "associate" stores?

15. What do you believe to be the future outlook for corporate chains? For voluntary chains? Give reasons to support your answers.

16. In the distribution of foods, how do you account for the differences in operating expenses of the retailer-owned voluntary chain, the wholesaler-sponsored voluntary chain, and the regular wholesaler?

17. You are acting as employment manager for a large national food chain. A man whom you would like to hire to fill one of your executive positions is now in your office. This man is debating as to whether he should work for the chain or establish an independent food store of his own. Explain to him the position of chain stores in the food field and present the advantages which they enjoy over independents.

18. As the prospective employee in the above problem, present the factors which you consider to be adverse to further chain store development in the food field.

19. The unit managers of a sectional grocery chain store operating in the Southwest have called the home office's attention to an intensive campaign launched against chain stores by an independent grocers' association. Extensive newspaper advertising is being used to carry such appeals as: "Keep your money at home," "Local business is being destroyed," and "Chains aren't paying a fair share of the taxes." Evaluate the economic validity of each argument. Assuming that you are director of public relations for this chain store, what action (if any) should or can be taken to cope with this situation? Explain.

20. Assume that you are an independent grocer with average ability, operating in a midwestern town of 100,000. Your business is subject to sharp chain store competition. During the past year your sales have declined 10 per cent. The leading wholesaler in town is affiliated with I.G.A. and a representative has been urging you to join. Also in the same town is a retailer cooperative which you could join if you wished to do so. What factors must be considered in determining with which organization it would be most desirable for you to become affiliated in this instance?

21. It is generally asserted that the Robinson-Patman Act was passed primarily for the purpose of eliminating or curbing certain practices of chain stores. Does this in any way have a similar effect on all voluntary chains or only on certain activities of some of such organizations? Explain.

11

SUPERMARKETS, SHOPPING CENTERS, DISCOUNT HOUSES

A number of important additions to or modifications in existing types of retailing institutions have taken place since 1946. In the 1920's, corporate chains expanded rapidly and became a vitally significant part of our distributive system. The principal contribution of the 1930's was the voluntary type of chain and the advent of the supermarket. In more recent years, three of the most notable developments have been the increased influence of supermarket merchandising methods, the rapid expansion of planned shopping centers, and the birth and attainment of an aura of respectability by the discount house. Each of these developments has made an important contribution and exerts a real influence on competition and on our way and standard of living.

SUPERMARKETS

Supermarkets have revolutionized the distribution of food. Their phenomenal success in the grocery trade has also had a persuasive influence upon the marketing of consumer goods of all classes. Supermarket merchandising techniques have been applied to some extent throughout almost all segments of the retail trade structure.

What Is a Supermarket? The term *supermarket* is very loosely used in marketing discussions. In general the concept conveyed is that of a very large, departmentized retail store dealing in dry groceries, produce, meats, baked goods, and dairy products. Very often such a store handles drugs, certain hardware and houseware items, and a variety of other classes of

merchandise. Emphasis is placed on large volume of sales, mass appeal, complete assortments, and price. Up to 1937 the idea was generally associated with that of a store located outside the downtown or neighborhood areas, in a factory or a barnlike structure which had formerly been used for industrial or recreational purposes.

Such a concept has been greatly modified because almost all the supermarkets constructed since that time have been of an altogether different type. Most supermarkets today are situated in neighborhood shopping district locations, in well-developed secondary shopping districts of large cities, or in the downtown areas of small or medium-sized cities. Much better buildings are used than in the earlier years; more emphasis is placed on display, service and assortments, and less on price. Many such markets are operated by national food chains; others are independently owned. Thus an inclusive but perhaps useful definition of *a supermarket is* that it is *a large retail establishment offering a relatively large and complete stock of dry groceries and other food products, supplemented sometimes by a variety of other convenience and specialty lines, and whose principal appeals are self-service, price, mass display, wide assortments, and convenient parking.*

Importance of Supermarkets. Any quantitative evaluation of supermarkets depends upon the precise criteria selected for classification purposes. The Bureau of the Census has thus far refrained from defining the term *supermarket* on the ground that there is as yet no agreement within the food trade as to precise definition, nor is there any such agreement among students of marketing. Unfortunately, the Bureau of the Census is the only organization that is in a position to make complete enumerations for the country as a whole. Other organizations, such as the national trade association known as the Super Market Institute, collect some statistics from their members; but no such organization or reporting agency obtains figures from all stores that might be classed as supermarkets.

The most serious problem encountered in attempting a statement regarding quantitative importance is that almost all definitions have included a minimal annual sales volume requirement which has varied, according to the viewpoint of the defining authority, from as low as $100,000 to as much as $1,000,000.[1] This has always proved disheartening when attempts are made to effect historical comparisons. Because of changes in the price level—which for grocery store items increased by 110.6 per cent over the period

[1] In one highly respected trade survey, supermarkets are defined to include any food stores, "chain or independent," doing $375,000 or more per year whereas stores doing over $75,000 but less than $375,000 are called "superettes." (See "Facts in Grocery Distribution," 1956 Edition, *Progressive Grocer,* p. 2.) In another, "a supermarket is defined as a complete, departmentalized food store with a minimum sales volume of one million dollars a year and at least the grocery department fully self-service." (See *The Super Market Industry Speaks—1956* [Chicago: Super Market Institute, 1956], p. 9.)

from 1939 to 1954—a store classified as a supermarket in one year might not be so classified in another, even though the physical volume of business had not changed significantly. This indicates the futility of incorporating into a definition a dollar sales volume requirement if the same definition is to be used for different periods marked by varying economic and price conditions.

Some criterion of size is nevertheless essential in gauging the importance of these institutions and dollar sales volume classification is the only one available for this purpose. While not precise, some indications of the growth of supermarkets can nevertheless be gleaned from such census data. In 1954, there were 21,460 grocery stores with an annual volume of more than $300,000 each. This classification, while arbitrary, is deemed reasonably representative of public impressions of stores commonly known as supermarkets and is believed to contain only a negligible proportion of establishments not operated on a self-service basis. The group represented only 8 per cent of the total number of grocery stores then in operation, but it accounted for about 58 per cent of the total sales volume of all grocery stores. By way of comparison, stores of similar sales volume size (in terms of physical volume or constant dollars) accounted for 43 per cent of total grocery store sales in 1948 and only 14 per cent in 1939.[2] Over the fifteen-year period 1939–1954, there has thus been about a fourfold increase *in the relative market position* of supermarkets.

History of Supermarkets.[3] There are random early examples of very large food stores such as Tiedke's in Toledo, Ohio, certain public market stores, and the L-type or drive-in markets which originated in California in 1918. But the real supermarket did not appear until the early 1930's, when "King" Cullen opened his first market in an abandoned Long Island garage with empty ginger-ale cases for display tables. The first "Big Bear" market was opened near Newark, New Jersey, in December, 1932, and in one year sold $3,600,000 of goods. The supermarket at once became the sensation of the food industry and a problem to manufacturers, wholesalers, and chain and independent retailers alike.

The supermarket seems to have been depression-born and stimulated by the severity of the economic crisis. Operators were able to occupy huge

[2] Data for 1948 derived from grocery stores with sales of more than $300,000. While food store prices increased about 8 per cent over the 1948–1954 period, this does not affect the comparison in an appreciable manner since most of the increase in supermarket volume is associated with stores materially in excess of the $300,000 level. For 1939, the data pertain to self-service food stores with sales in excess of $150,000, which is the nearest physical volume equivalent to $300,000 in terms of 1954 prices. Data from the *U. S. Census of Business* for the respective years.

[3] For a detailed historical account, see M. M. Zimmerman, *The Super Market—A Revolution in Distribution* (New York: McGraw-Hill Book Company, Inc., 1955), chaps. i–vii.

buildings for low rent, to obtain merchandise in large quantities from distressed sources. They had an almost inexhaustible customer market with depleted purchasing power eager to turn every dollar into as many necessities as possible. Price was the common appeal made by such a market. There was little need for a convenient location, fancy fixtures, displays, or service. Hence some of these markets incurred operating expenses in the early years of as little as 6 or 8 per cent of sales and were able to operate satisfactorily with a gross margin of profit in the range of 9 to 12 per cent of sales, which was considerably lower than the average gross profit in the then typical chain counter-type store and still lower than that of the typical independent food store. Thus the early supermarkets reduced by nearly one-half the margins prevailing in the food industry and, as a consequence, brought great turmoil into the market.

The first supermarkets were opened by independent merchants. The large grocery chains did not follow their lead until it became clear that something more than selling food from empty boxes and in an abandoned barn was involved. When the validity of the principles upon which the supermarket is based became clearly established, the chains entered into active competition with the pioneer independents and today, as shown above, this type of store is of outstanding importance in their operations. The chains, and the successful independents as well, began to provide stores built upon the most modern lines and using fixtures, lights, and other equipment of the most modern type. Summertime air conditioning is becoming common, as is the use of highly effective refrigeration display cases, often of the self-service type.

Chain store organizations now dominate the supermarket industry for two reasons. First, many of the original independent supermarket operators were highly successful and became multi-unit organizations as profits from the first units were reinvested in new locations in the 1930's. In all parts of the country are to be found important local chains of stores which can be traced to the birth of the supermarket as a retailing institution. Second, the large national and sectional chains which were already well established during the middle 1930's were quick to adapt their operations to this new method of merchandising as soon as its soundness became apparent. Since 1933, the operations of almost all of the older and larger chains have been characterized by the policy of closing down small units and replacing them with larger and fewer stores of the supermarket type.

It must not be inferred, however, that supermarkets today are altogether of the chain variety, as there is a considerable number of independent markets of this type, some with annual sales in the \$2–\$5 million range. According to one trade study, independent supermarkets and superettes—medium-sized stores that have adopted supermarket methods to a high degree—accounted for more than one-fifth of the total number of independent

food stores and four-fifths of their total sales volume.[4] Many of these are affiliated with some type of voluntary chain organization.

Merchandising Strategy. Certain fundamental merchandising and operating policies are followed by a majority of the nation's supermarkets. An understanding of these is important because, to some extent, they differentiate the supermarket from other types of retail institutions and because they provide an explanation for consumer attraction to stores of this kind.

Self-Service. Self-service is by definition a supermarket characteristic, one that has been common to all stores of this type since their inception. For many years self-service operations were limited largely to dry grocery departments. At least some form of personal service was provided in fresh fruit and vegetable departments, and meat markets were generally operated on a clerk-service basis. The trend has been toward an extension of the self-service method to all departments. Many organizations now package produce in visible wrappings with prices and weight or count clearly marked in order that consumers may make selections without any assistance whatsoever from a store employee. In the years following World War II self-service has been applied on a large scale in meat departments. It has been estimated that in 1945 there were but 15 supermarkets with complete self-service meat departments,[5] but by 1956 it was reported that 82 per cent of the chain supermarkets were operating meat departments on a complete self-service basis.[6]

National Brands. With the exception of a limited number of the largest chains whose private brands are about as well known to consumers as many manufacturers' national brands, merchandising strategy generally calls for emphasis upon nationally advertised brands. As a general rule, little promotional effort is devoted to private brands. Even in the supermarkets of regular chains the sales are far larger in national brands than in their other stores. The reason for emphasis on well-known brands is obvious. Since there are no salespeople to explain, to suggest, and to urge the purchase of unknown or private brands, the store must carry merchandise which needs no personal point-of-sale effort. Hence the consumer is simply allowed to select the merchandise she wishes without assistance or urging by the store's employees.

Price Appeal. An important policy is that of featuring prices. Although other motives explain a large part of supermarket patronage, price is cer-

[4] "Facts in Grocery Distribution," 1956 Edition, *Progressive Grocer,* p. 11. See note 13 in Chapter 10.

[5] Sam Teitelman, "Self-Service Meat Retailing in 1950," *The Journal of Marketing,* January, 1951, p. 309.

[6] *The Super Market Industry Speaks—1956, op. cit.,* p. 19. Except where otherwise indicated, specific items of information concerning supermarkets are based on the contents of this publication and its earlier annual issues.

tainly among the dominant motives. Moreover, price-marking for all items of merchandise is a general necessity under the self-service method of operation. Such stores follow odd price policies, which are intended to convey a bargain impression. In many stores, cash registers with a "½ cent" register key have been installed, with the intention of giving the consumer the impression that the organization is attempting to save even fractions of a cent. The great majority of supermarkets consistently feature *special* low prices on items in week-end advertising. The remaining companies do not neglect the price appeal; on the contrary, their advertising emphasis is generally on some such expression as "Same Low Prices Every Day."

Wide Range of Merchandise. Because of the large size of supermarkets, they are able to offer a great variety of merchandise and, within the lines carried, they also have more extensive assortments than their competitors in the food field. Whereas the ordinary small grocery store stocks from 500 to 1,000 items, the supermarket usually has about 5,000 or more. It has been demonstrated time and time again that such a large variety and extensive assortment increases the purchases of the average consumer, who cannot resist the cumulative force of mass displays. The result is that many items or quantities are bought more or less on impulse rather than on the basis of advance planning or any previous general consideration.

On the average, about 63 per cent of supermarket sales volume is accounted for by the "grocery" department, about 23 per cent by the meat department, and about 11 per cent by the produce department. The term "grocery department" as it is commonly employed in the trade is practically a misnomer, for it includes many items which are not sold in ordinary grocery stores. Nonfood sales amount to about 7 to 10 per cent of total store sales in most supermarkets. Some of the nonfood merchandise classifications, together with the percentage of supermarkets in which they are stocked, are as follows: health and beauty aids, 92 per cent; housewares, 75 per cent; children's books, 73 per cent; nylon hosiery, 54 per cent; stationery, 53 per cent; general magazines, 52 per cent; toys, 48 per cent; glassware, 42 per cent; children's records, 34 per cent; hardware, 28 per cent; greeting cards, 22 per cent; underwear, 16 per cent; and electrical appliances, 15 per cent. There is a marked tendency for supermarket operators in the western regions to carry more nonfood items than those in other parts of the country. Regardless of location, supermarkets do not attempt to maintain complete assortments of these nonfood classifications but rather limit their stocks to such items as have a rapid rate of stock turnover and which are susceptible to sale by the self-service merchandising technique.

High Average Sale. The average sale in supermarkets ranges from 3 to 4 times the value of the average sale in ordinary grocery stores. One important explanation for this is the large amount of emphasis on week-end

shopping. Many markets find that 70 per cent or more of their sales is made on Fridays and Saturdays. There are several reasons for this concentration. Grocery shopping is now often a family proposition for which there is more time at the end of the week. Most families now have fairly large home refrigerators, capable of storing substantial quantities of food for a number of days. The increased use of the automobile has made it easier for consumers to transport large quantities from stores to their homes.

In addition to the week-end shopping concentration, there are other factors contributing to the high average sale. One of these is attributable to the wide range of merchandise carried. Consumers buy more different kinds of items in supermarkets than in ordinary stores. Another reason is the importance of so-called impulse or unplanned purchases that come from attractive mass displays.

Parking Facilities. Large amounts of ground area for parking facilities are provided in connection with most supermarkets. While some customers come on foot or via public transportation facilities, the supermarket is essentially a concomitant of the automobile age. In the construction programs in the years following World War II it has been customary to provide parking space equal to about three times the floor area of the store building, whenever sufficient ground area could be obtained in connection with a desired location.

Dynamics in Supermarket Operation in the 1950's. The basic character of supermarket merchandising strategy was well established, in terms of the features discussed above, prior to the 1940's. The supermarket business has, however, continued to be one of the most dynamic of any in our retailing structure. Operators in this field have been hard pressed to keep abreast of new developments and to adapt their businesses to changing conditions. Nevertheless, they have manifested an amazing ability to cope with problems of continuing innovation, adjusting their operations to the changing requirements of customer preferences.

During the 1950's, a number of trends in supermarket operation were clearly in evidence. One of these relates to size of the establishment. In 1949, the "ideal" size of supermarket was deemed to be about 11,700 square feet of total floor space, but by 1956 it was changed to 20,000 square feet, or an increase of more than 70 per cent. Many of the leading national chains were building markets of about 30,000 square feet and one organization opened a market of some 81,000 square feet in 1956.[7]

Second, supermarkets have adjusted their store hours to provide greater opportunity for family shopping. Between 1951 and 1954, the per cent of

[7] "Midwest Grocer Maps Happy Adventure for Shopping Housewives," *Wall Street Journal,* July 31, 1956, p. 1.

supermarkets open for business every evening of the week increased from 27 to 46, and the per cent open on Sunday increased from 9 to 16.

Third, by the mid-1950's many types of store refinements were considered essential to a modern supermarket. By way of contrast with the barn-like atmosphere of the early 1930's, most contemporary planners incorporate elaborate facilities including "Kiddie Korrals," rest rooms, better lighting, striking color combinations, murals, automatic doors, parcel conveyors, in-store music, air conditioning, and a variety of other customer-pleasing devices.[8]

Fourth, there has been a great increase in the number of items handled in such stores. The growth of nonfood merchandising, which was discussed in the preceding section, is largely a modern-day phenomenon. The increases in merchandise items have not, however, been restricted to the nongrocery segment of the business. One Ohio supermarket organization that carried some 40 frozen food merchandise items in 1950 was stocking as many as 225 such items in 1955. In the latter year it was carrying 104 different items of heavy consumer demand in the category of cake and pie ready-mixed products, almost all of which were of very recent origin.

Fifth, supermarkets have engaged in a variety of scientific work simplification programs and have made great strides in the use of mechanized equipment in receiving and handling merchandise, prepackaging of meat and fresh produce, price-marking, and check-out stand operation. As a consequence, great strides have been made in the productivity of store employees. Over the period 1951–1956, when retail food store prices were relatively constant, sales per full-time store employee equivalent increased from $29,700 to $43,400. This is an increase of 46 per cent in sales per employee, a record which, it is believed, cannot be matched by any other kind of major retailing institution.

Sixth, the use of trading stamps, discussed as a sales promotional device in Chapter 21, increased with growing competitive pressures among supermarket organizations. In 1955, 40 per cent of all supermarkets gave trading stamps to consumers as compared with only 13 per cent in 1953. The cost of trading stamps ordinarily amounts to about 2 per cent of retail sales volume, but is commonly regarded as a competitive necessity in metropolitan markets where such stamps have wide consumer acceptance and where their distribution is widespread among supermarket operators.

As a consequence of some of the above factors, especially those pertaining to merchandise line expansion, trading stamps, and increased customer facilities, and because of rising wage rates, operating expenses and gross margins in supermarkets have tended to increase. In 1955, operating ex-

[8] "Facts in Grocery Distribution," 1956 Edition, *op. cit.*, p. 6.

penses of supermarkets amounted to about 15 per cent of total sales volume,[9] a substantial increase from the 6 to 8 per cent achieved by some of the supermarkets in the early 1930's. Nevertheless, the supermarket continues to be one of the most economical forms of retailing in the lines of merchandise in which they deal.

Future of the Supermarket in the Grocery Trade. In the early years of supermarket merchandising in the food field, this form of retailing grew rapidly, at the expense of the relative market position of traditional clerk-service type food stores. By the mid-1950's, it was apparent that supermarkets were rapidly approaching a relatively stable market position. Most consumers who wish to buy in this type of store now have the opportunity to do so. Supermarket chains are now hard pressed to find desirable locations for new establishments because supermarkets are to be found in most market areas where the population potential is adequate to support a large volume store. The major competition for supermarkets is now with other supermarket organizations rather than with smaller, service types of stores. This suggests that supermarket expansion in food sales will, in the future, be at a less rapid rate, more in line with increases in population and buying income. As a point of saturation is approached, the supermarket will be able to increase its share of total consumer expenditures only by continuing to expand activities in nonfood merchandising. The opportunity for doing this on a large scale does not seem particularly encouraging because of the manner in which retailers in other lines are adapting their operations to take advantage of some of the appeals and operating economies of supermarket merchandising strategy. Nevertheless, it is expected that the supermarket industry will be one of continued growth and development, merely because of the long-run market increases attributable to population expansion and rising income standards. As population grows, especially in suburban market areas, many new, large, and ultra-modern supermarkets will be opened to serve the needs of people in these areas.

Impact of Supermarket Merchandising Methods on Other Lines of Trade. The degree to which supermarket methods have resulted in modification in operating practices in other kinds of business is a question which cannot be answered categorically in quantitative terms. The impact is, however, visually evident among newer or modernized stores in almost all segments of the retailing structure.

In department stores, the tendency has been to avoid the "limited-service" connotations of "self-service" operation, but many such stores have approached supermarket merchandising strategy by increasing the extent of

[9] "Facts in Grocery Distribution," 1956 Edition, *op. cit.*, p. 19; see also, *The Super Market Industry Speaks—1956, op. cit.*, p. 11. Operating data are also reported in *Super Market Merchandising*, August, 1956, pp. 64–65.

open display and by utilizing conspicuous "transaction processing stations." These are, in reality, a disguised form or modification of the supermarket check-out counter, and are often identified with signs such as "Bring Your Own Selection Here for Quick Service." Applications of this type of merchandising have been most common in departments that handle easy-to-select types of items, such as greeting cards, notions, housewares, books, and toys.

Most of the newer stores operated by major variety and drugstore chains are of unusually large size, utilize open display fixtures that expose merchandise items in the majority of the classifications, and have a number of regular check-out counters concentrated at the front of the stores in a manner almost identical to that of the grocery supermarket. The layout of new or modernized hardware and automotive accessory stores reflects a similar trend, with emphasis upon self-selection and a greater diversification of visually displayed merchandise than characterized such stores in the past. Even in the apparel field, the supermarket has had considerable influence. The Robert Hall chain of clothing stores has grown from a relatively small to a nationally known organization by utilizing, to a high degree, self-service merchandising methods. Many other apparel retailers have made similar adaptations in their methods. Even in the shoe field, a limited number of stores are operated on a self-service basis, to the extent of allowing consumers to do their own fitting and taking their merchandise to the check-out stand. So extensive has been the influence that many establishments in nonfood lines are publicized as "supermarket" drugstores, hardware stores, nurseries, or even lumber yards.

Many supermarket adaptations have been experimental and have failed because the need for some type of personal selling assistance was overwhelming, at least for some merchandise items or for some customers who prefer personal assistance. Successful innovations in nonfood stores have usually rested upon a new approach to the handling of the retail sales transaction. Under traditional "clerk-service" forms of retailing, the consumer is totally dependent upon the service of a regular salesperson for all phases of the transaction. The influence of supermarket merchandising has been essentially that of dividing sales transactions into two major components—first, the merchandise selection aspect and, second, the recording aspect. Under modern methods of selling, the first can be handled *either* by the consumer through the process of self-selection *or* by the salesperson who assists the consumer with personal selling advice. The recording phase is handled at some kind of a centralized check-out counter or transaction processing station which is equipped for this purpose and manned by personnel especially trained for this activity.

The majority of retailers who have attempted well-planned modifications of their operations by utilizing supermarket merchandising strategy have

derived substantial advantages. The prevailing tendency has been for sales to increase when clerk-service stores are converted to a self-selection basis. This is attributed to several factors. First, the influence of store modernization which is in harmony with contemporary consumer buying habits undoubtedly plays a major role. Second, many more merchandise items are exposed to consumer contact and it is widely accepted that consumers buy more on impulse from open displays than they do in clerk-service stores. Third, personal selling efficiency tends to improve, because this type of selling is largely confined to merchandise classifications in which the consumer actually requires buying assistance.

Self-service methods have generally had a favorable influence upon store profits. In part, this is attributable to a larger volume of sales per establishment. It is also due to a smaller amount of employee time per transaction or greater volume of sales per employee. This results from the fact that people tend to help themselves in the case of familiar "easy-to-choose" items. Trained salespeople are thus able to concentrate their efforts on higher unit value transactions where assistance is required because of the technical character of goods, or because of special compounding or fitting problems, as in the case of appliances in hardware stores, prescriptions in drugstores, and suits in men's clothing and furnishings establishments. As a result of these factors, many retailers have found that they can handle a considerably larger volume of sales in an establishment of given size without adding to the number of employees required to care for the greater number of transactions involved.

PLANNED SHOPPING CENTERS

Planned shopping centers are, by and large, a very recent phenomenon. They are not retailing institutions in the ordinary sense but rather are spatial arrangements or groupings of stores that have been planned to provide a balanced and controlled shopping attraction for the area served. Until the mid-1950's such centers were widely considered as an institutional innovation. Many of the early centers were fabulously successful. They brought needed services to suburban areas, provided high operating profits to many of their major tenants, and often yielded fabulous returns on investment to their promoters.

Characteristics of Planned Shopping Centers. All major cities have a number of secondary business districts which have evolved gradually over a long period of years as a consequence of many individual location decisions made by a wide variety of business firms. Planned shopping centers of the modern variety differ from these uncontrolled business districts in a number of respects. All of the land and buildings in a planned center is typically owned by the developing organization which gives it an unusual measure of

control over architectural, parking, store arrangement, service, and other facilities. Second, a balanced grouping of different kinds of stores and service establishments is provided for the purpose of affording a one-stop kind of shopping. Third, the greater part of the available ground space is used for free automobile parking. Ratios of parking space to store selling area are commonly about 3 or 4 to 1. Fourth, such centers are developed according to an over-all plan prepared with the help of architects, market analysts, traffic engineers, and other specialists prior to initial construction of the first rentable units in a new center.

Planned shopping centers are of various types, distinguished according to their size, nature of tenants, and extent of trading area served.[10] At one extreme, there are neighborhood centers which usually consist of a strip of some 6 to 12 stores of the convenience goods and service establishment types. At the other are to be found very large regional centers which may have 50 to 100 stores, including one or more department store units, a number of almost all kinds of shopping goods stores, several variety store chains and supermarkets, and a group of convenience goods stores and service establishments. Such centers are usually developed on tracts of land in excess of 40 acres, commonly provide parking for 4,000 or more automobiles, and may draw customers from a trading area of as much as some 20 minutes driving-time radius.

Ownership Interests. Many different types of ownership interests have been involved in the development of planned shopping centers. One common class consists of residential real estate developers who provide for shopping center facilities as part of the master plan for large suburban subdivisions. A second class consists of a number of organizations that specialize in the business of building and operating planned shopping centers. Some of these organizations employ a large staff of market analysts, real estate appraisers, architects and designers, and administrative personnel. One of the best known of these is the Don M. Casto Company of Columbus, Ohio, which has developed, owns, manages, and promotes some 25 large planned shopping centers and many small ones located in eight different metropolitan areas and in a number of small cities.

A third type of ownership interest is represented by regular retailing companies that develop shopping centers in which they wish to become major tenants. Examples in the department store field include the J. L. Hudson Company of Detroit which developed Northland and Eastland regional shopping centers in that city; the Allied Stores Corporation, builders of

[10] There is no common agreement regarding classifications or definitions of types of planned shopping centers. For a listing of definitions cited from various sources, see Eugene J. Kelley, *Locating Controlled Regional Centers* (Saugatuck, Conn.: The Eno Foundation, 1956), pp. 5–8.

Bergen Mall, near Paramus, New Jersey; and the R. H. Macy & Co., Inc., developers of the Garden State Plaza Shopping Center, also near Paramus in the New York City metropolitan area. As another example, Food Fair Stores, Inc., a large eastern food chain, established a subsidiary, Food Fair Properties, Inc., in 1956, for the purpose of developing planned shopping centers in which it will have the first opportunity of locating its own supermarkets under exclusive 25-year leases.

Reasons for Growth of Shopping Centers. The decade following World War II offered an environment especially favorable for large-scale development of planned shopping centers. During the war years, new retail store construction and home building were almost at a standstill. Immediately following the war, as was pointed out in Chapter 3, new families were formed at an unprecedented rate, and by 1947 the birth rate had soared to unparalleled levels. Business conditions were excellent and family buying incomes were high and rising. This condition was especially opportune for a substantial housing boom in surburban areas of major cities. The 1950 Census of Population revealed that the suburban portions of the largest metropolitan areas had increased, since 1940, at a rate about four times that of the central cities; since 1950, it is believed that the rate of suburban population growth has been even greater. Thus, in a real sense, the suburban shopping center surge of expansion was largely a matter of retail stores following the population.

A second major factor consists of the more widespread ownership and greater usage of the automobile. In 1920, there were only about 20 million privately owned automobiles in the United States but by 1955 the number increased to about 52 million. This gave rise to serious problems of congestion and created parking difficulties within the central business districts of cities. Longer distances to be traveled from newer residential areas to such districts discouraged frequent visits by suburbanites. Increased utilization of automobiles also adversely affected many outlying neighborhood business districts, since it made the consumer more independent and more willing to travel rather appreciable distances for even ordinary items needed for daily living. Thus the planned shopping center, with its significant feature of large free parking areas, presented a patronage appeal that was in harmony with contemporary living patterns.

Another major factor is to be found in the change in consumer buying habits. As a result of mass market advertising in media of widespread circulation, consumers are better informed about the availability of merchandise items than at any previous time. Women are busier, either at work or in a variety of social pursuits. There is, consequently, a greater willingness to shop from the somewhat limited assortments available in suburban shopping centers, especially when the advantages of convenience, informal-

ity, and ease of parking are set in contrast with conditions associated with trips to central business districts.

Competitive Position of Stores Located in Planned Shopping Centers. The controlled type of shopping center, especially the larger ones, holds for its tenants a number of *advantages.* Some of these are obvious from the foregoing description of characteristics and reasons for growth. One is the convenience of adequate free parking. A second consists of the balanced shopping attraction which affords the consumer an opportunity for a one-stop buying expedition. Third, the uniform architectural treatment is generally attractive. Fourth, all stores located in such centers are, at this early stage of development. newer and more modern than those located in competitive types of locations. Fifth, individual stores benefit from aggressive promotion of the center as a whole, at least in contrast with more limited community efforts typically associated with unplanned business districts. Sixth, most planned shopping centers provide a greater number of night openings, which has been especially attractive from the standpoint of family shopping.

These advantages have, in large measure, accounted for the substantial growth of planned shopping centers in the period following World War II. Although some large planned shopping centers were in existence before 1945, there were only a handful throughout the United States. By 1956, it was estimated that there were as many as 1,600 planned shopping centers in operation, of which about 600 had been opened in the preceding year, and public announcements had been made about some 2,500 additional centers which were then in the planning or construction phases of development.[11]

Studies in many large cities have indicated that retail trade in planned suburban shopping centers has grown at a much more rapid rate than the volume of sales in central business district stores. This is not at all surprising, but only to be expected because of the very limited sales volume importance of such centers during years used for comparative purposes, usually 1947 or 1948. The fact that downtown retailers have diminished in *relative* importance, even though they may have grown or held their own in terms of *absolute* sales volume, has, nevertheless, been a source of considerable alarm, not only from the viewpoint of the retailers themselves, but also on the part of real estate owners and civic leaders who are interested in preserving the value of the tax duplicate on central business district

[11] S. O. Kaylin, "Shopping-Center Boom Continues," *Chain Store Age—Administrative Edition,* May, 1956, p. 27. In another source it was estimated that there were about 1,000 shopping centers in existence in 1955 and about 2,000 under construction or planned at that time (*Distribution Trends,* Washington: U. S. Chamber of Commerce, 1956, p. 7).

properties. Growth of suburban retailing has led to various types of defensive measures on the part of such downtown merchants, also by civic action. Many urban department stores have taken steps to modernize their establishments, provide parking facilities, improve their merchandise assortments, and increase the aggressiveness of their advertising. Municipalities have entered the picture by providing public off-street parking; curtailing congestion by the construction of expressways, placing restrictions on on-street parking, increasing the number of one-way streets in the central business district, and taking various other measures to increase the attractiveness of the central business district. As a result of these steps, the downtown areas of a number of major cities were, by 1956, more attractive to consumers than they had been at any time during the preceding decade.

In spite of the disadvantages of downtown shopping, many consumers still prefer to shop downtown. The major competitive advantages generally associated with consumer preferences for central business district shopping are, first, a wider range of merchandise offerings available in the larger and more numerous stores to be found there and, second, the attraction of dominant sales promotion events publicized in metropolitan area newspapers and other media. Other benefits derive from consumer thinking that this area is a better place to meet friends, to have lunch, to buy at the best prices, to obtain more numerous services including delivery, and to combine shopping with other things that one may want to do.[12]

The growing number of planned shopping centers, together with the various defensive measures taken by central business district interests, have resulted in a more competitive era for planned shopping centers. Whereas the early centers enjoyed an almost unchallenged opportunity to serve new and rapidly growing suburban areas, many of them are now in aggressive competition with other centers located only a short distance away. Multiplication of centers in some cities has greatly curtailed the trading area that can be served most advantageously by any individual center and has limited the opportunities available for new developers. In most of our largest cities, the point has been reached where a new planned center can be properly developed and promoted only as a result of successful competition with rival centers. From the standpoint of future development, the need is evident for greater emphasis upon sound market analysis, the best architectural planning, a truly distinctive group of outstanding retail tenants, and the provision of various kinds of attractive community services and entertainment facilities.

[12] For a quantitative appraisal of these and other factors, see C. T. Jonassen, *The Shopping Center versus Downtown* (Columbus: The Ohio State University Bureau of Business Research, 1955), pp. 38–43.

Discount Houses

In the decade following World War II, one of the most highly publicized developments in retailing was the expansion in the extent of "cut-price" retailing of appliances, furniture, and other items, chiefly in the durable goods category. Some of the major forms of discount selling, the principal explanations for it, and its influences upon the marketing structure are explored in the following paragraphs.

Discount Selling versus "Discount House." In the late 1940's and early 1950's, numerous articles on the subject of discount retailing appeared in the popular and business press. Many of these contained suggestions that widespread selling "below regular or list" prices was a new phenomenon. Many also contained estimates of the amount of business transacted at discount or below-list prices. Such estimates varied greatly, and have generally been without any reliable statistical support. Agreement has been general, however, that discount selling was increasing over this period and that it accounted for substantial proportions of consumer durable goods purchases.

Part of the confusion on this subject arises out of the failure to distinguish between various forms of "discount selling" which are rather widely practiced by regular retailers on a discriminatory basis as well as by "discount houses" which are retail establishments that consistently offer all or most of the merchandise items in their stock at prices below so-called list or regular prices. Consumers believe that they are buying at a discount under a variety of circumstances as when they: (1) are able to negotiate a lower price by bargaining or higgling with a retailer; (2) are accorded special privileges by virtue of membership in some organization or affiliation with some group; (3) buy from an establishment which actually is, or is represented to be, a wholesale place of business; or (4) purchase from a store which, as a matter of policy, consistently sells below regular or "fair trade" prices.

Discount selling has been practiced, at least to some extent, by many kinds of retailers over decades. Some gasoline service stations offer certain favored customers discounts of two or three cents per gallon from posted prices. Practically all automobile sales that involve trade-ins have been "negotiated" for many years, with the effect that the skillful and persistent bargainer obtains a "better deal" than many other purchasers. In some furniture and appliance stores, customers who manifest resistance to posted prices are turned over to another salesman who presents a more attractive offer. Drugstores commonly give "professional discounts" to physicians, especially to those who favor the store with prescription refer-

ences. Many retail stores, as well as wholesale and manufacturing companies, sell to their own employees according to some discount policy.[13]

Types of Discount Houses. Most discussions of discount selling in the late 1940's and the 1950's have not been concerned so much with the aforementioned types of examples of occasional discriminatory selling on the part of regular stores as with a surge in the volume of durable goods business accounted for by establishments generally recognized as a regular source of discount prices. A number of such "discount houses" existed at least as early as the 1930's.[14] Most of the earlier types were located in out-of-the-way places and not widely publicized. For the most part, they catered to a restricted or private clientele.

Several major types of such discount houses have been rather common.[15] First, in the furniture field and in certain other trades there are "open showrooms," operated by manufacturers and wholesale middlemen, for the purpose of maintaining centralized displays for small dealers and decorators who cannot maintain full stocks in their own establishments. While it has been conventional to admit consumers only upon introduction from a retailer, many such establishments have willingly done business with anyone who visited them. Consumers buying from showrooms of this kind usually believe, sometimes without justification, that substantial price concessions are thus obtained.

A second type consists of some form of brokerage buying arrangement. Certain appliance repairmen, upholsterers, and other types of service establishments that have access to wholesale sources of supply have rendered such service to their regular customers and others. Usually they have no stocks of merchandise, but may agree to purchase specified items for consumers at cost plus some brokerage or buying fee of about ten per cent of cost. In some cases the amount of this type of brokerage buying has become such a dominant character of the business that it becomes known as a discount house.

Third, there have been many rather large retail establishments offering merchandise at discount prices to consumers who are members of certain groups or organizations. Little publicity is given to their operations other than through "purchase privilege cards" issued to members of such groups as city employees, teachers, members of labor unions, and persons with a

[13] For a detailed discussion of many kinds of discount selling, with numerous historical references, see Stanley C. Hollander, "The One-Price System—Fact or Fiction?" *Journal of Retailing*, Fall, 1955, pp. 127–44.

[14] *Ibid.* Reference is made to a list of some 26 discount houses or open showrooms (one of which was 30 years old), published in the trade newspaper, *Retailing*, in December, 1937.

[15] For a more detailed classification of nine types of discount houses found in the Los Angeles area, see F. W. Gilchrist, "The Discount House," *The Journal of Marketing*, January, 1953, pp. 267 ff.

recognized professional status. Many of these organizations are small, as judged by the size of the facilities which they occupy, but do a large dollar volume of business. They usually do not carry stock on major items, but order merchandise for customers who make purchase decisions from stocks displayed in other retail stores or from catalogs in the discount houses.

All these earlier forms of discount houses have continued and are of contemporary significance, at least in a large number of major metropolitan areas. In many large cities, they have taken a position secondary to that of a more modern type of discount house, which is open to the general consuming public, carries large stocks, renders some types of consumer services, advertises regularly, occupies a good retail store location well exposed to consumer traffic, and can be distinguished from regular retailers only by its consistent emphasis upon "discount prices" and its self-designation as a "discount house."

Reasons for Growth of Discount Houses. A number of factors have contributed to the substantial growth of discount houses in the late 1940's and early 1950's. A rather significant redistribution of purchasing power has undoubtedly had some effect. As indicated in Chapter 5, the lower and middle income groups experienced the greatest increases in real family buying income and this brought many new families into the market for various kinds of durable goods. Many of these families were not accustomed to the wide range of services offered by department stores, furniture stores, and regular appliance dealers and were willing to purchase in the somewhat less attractive and more limited-service atmosphere of the discount house.

Second, there is some relationship between the impact of supermarket merchandising methods and discount house operation. Increasing emphasis throughout the economy upon such methods contributed to greater willingness on the part of the consumer to arrive at purchase decisions without the usual services of a retail salesperson. Consumer confidence in heavily advertised brands of appliances and furniture removed some feeling of dependence upon the integrity of the retailer and made consumers more willing to purchase on a self-selection basis in almost any type of outlet.

Third, and undoubtedly of greatest importance, is the discount house's consistent appeal of substantial price savings. This was made possible, in part, by a merchandising strategy geared to the requirements of *mass market* rather than *limited market* retailing, especially in the case of the more modern promotional type of discount house. This can be understood by comparing certain characteristics of appliance marketing in the periods prior to and following World War II. The postwar era was characterized by great increases in the capacity for manufacturing, accomplished largely through more automatic methods of producing goods in highly mechanized new factories. Durable goods poured forth from these factories in quantities

that can only be described as staggering by prewar standards. They flowed, nevertheless, into a distributive system that possessed essentially the same attributes it had in the earlier years. It consisted chiefly of a very large number of retail stores, most of which continued to appeal to limited segments of the total market, and in which a relatively large amount of personal selling and service effort was required for the consummation of the ordinary transaction.

Retailer margins that had become traditional in the prewar economy were, for the most part, perpetuated in the greatly expanded postwar market. Such margins were originally established by manufacturers in the form of trade discounts from list or fair trade prices, to compensate dealers for certain traditional services they were expected to perform. Historically, these services included the retailer's obligation to engage in local advertising and to devote creative selling effort to the manufacturer's line; to display a line of merchandise in an accessible store location; to assure quality to the consumer by serving as the agent through which the manufacturer can implement his warranty and maintenance policies; to provide credit and delivery service to the consumer; and to furnish installation service, if appropriate, and repair and maintenance service after sale.[16] In the appliance field this has resulted in traditional margins ranging from a low of about 25 per cent of retail list price for the most popular models of table television sets to more than 40 per cent on the slowest selling lines of relatively expensive kitchen and laundry appliances that require installation service.

Part of the discount house's success in underselling regular merchants is explained by its ability to operate profitably at lower expense by dispensing with some usual retail store functions. Another factor in expense reduction is that the more modern types of discount houses attempt to maximize profit by selling a large volume of items at a low percent-to-sales profit; by obtaining high rates of stock turnover, large profits can be realized on the capital investment in inventory.[17] Traditional retailers, on the other hand, have customarily striven to obtain a relatively high profit per unit of sale at lower rates of turnover.

Large volume discount houses operating on a limited-service, high turnover basis can probably save as much as one-half of the operating expense

[16] For an evaluation of the background and status of certain such services, see R. S. Alexander, "The Discount House and Prices," in Stewart Rewoldt (ed.), *Frontiers in Marketing Thought* (Bloomington: University of Indiana Bureau of Business Research, 1955), pp. 61–69.

[17] Sol Polk, operator of a world famous supermarket type of appliance and furniture discount house in Chicago, is reported to achieve a return of 36 per cent on his invested capital, by operating on a net profit of only 2 per cent of sales, while achieving a rate of turnover of sales to capital investment of 18 times annually. Edward M. Barnet, "Showdown in the Market Place," *Harvard Business Review*, July–August, 1956, p. 89.

ratio traditionally incurred by the regular or full-service retailers in appliances and related trades. This factor has made it possible for them to offer discounts ranging from about 12 or 13 per cent of regular list price on low margin items to about 20 per cent on higher margin goods. Many discount houses have publicized savings amounting to much higher percentages of list prices, and these. if they exist, cannot be explained by any operating cost advantages.

Several additional factors help to explain the basis for the price appeal of the discount house. One is that many discount houses have been able to obtain discriminatory prices and other probably unearned benefits from their suppliers. During the late 1940's and early 1950's, production capacity in the appliance industry was considerably in excess of the requirements of current market demand. Some manufacturers were attempting to obtain a share of the total market greater than could be realized by them, with a natural consequence of overproduction. This prompted them to seek outlets in addition to their regular channels of distribution. One such outlet was the so-called "builders' market," which consists of large-scale home builders who purchase appliances for installation in new residences. In the belief that there is great advertising value in having their items so installed, and that this is "plus business" that cannot be obtained through regular retail dealers, such manufacturers began to give unusually large discounts to builders. These discounts have been so substantial and attractive that the so-called builders' market became a source of supply to discount houses. Thus, items ostensibly sold to customers in the builders' market have never been installed in new homes, but have found their way into the discount house market at a cost to the latter much below that of the appliance dealer or department store.[18] Some large-volume discount houses have also been able to obtain other concessions from manufacturers, including advertising allowances and so-called "push money" for retail salesmen, which may not have been offered to regular retailers on proportionally equal terms.[19]

Another reason for *apparent* savings by discounters is that regular or list prices for some items have been established at fictitious or unreasonably

[18] In September of 1956, officials of the National Appliance & Radio-Television Dealers' Association requested the Federal Trade Commission to investigate trade practices which were believed to be illegal. Among other things, these included allegedly large discounts granted to builders and the failure of manufacturers to control distribution so that merchandise sold at builder discounts does not wind up in retail channels. See "Appliance Dealers Protest to FTC Over 'Low Price' Sales to Builders," *Business Week,* September 22, 1956, p. 54.

[19] In December of 1955, a group of nine Chicago retailers brought suit against several manufacturers, their wholesale distributors, and two discount houses (Polk Bros. and Rossi Bros.), charging discrimination in favor of these two discount houses by the "granting of exclusive promotion and advertising allowances, and special deals on demonstrators and salesmen." See "Dealers Find a New Enemy," *Business Week,* January 28, 1956, p. 61.

high levels, in relation to wholesale prices. Discounting was, therefore, only a natural economic consequence. This has resulted in situations where certain discount houses have offered some items at discounts greater than 50 or 60 per cent of regular prices. Considerable confusion has resulted from this. For example, meteoric growth in sales of electric rotisseries was cited by one writer to illustrate the manner in which the discount seller is presumed to speed the introduction and acceptance of new products.[20] In the example, a list price of $69.95 is compared with prices offered by discount sellers of some $28 to $29. An expert in the appliance industry, in referring to this example, stated emphatically "that this article never sold in any store, discount or otherwise, for over $30.00, and that the public in fact was bilked by a fictitious, phony (but I got such a good discount), list price."[21]

Another factor that has contributed to popular impressions regarding substantial price savings consists of the kind of selling tactics used by some promotional types of discount sellers. It is a reasonably common practice to advertise a "leader item" (e.g., a small refrigerator with very few special features) at a price near or sometimes below the cost of the merchandise. Salesmen are paid little or no commission on such items (sometimes referred to in the trade as "nailed-down step-ups") and are motivated and trained to "switch" the consumer to some more expensive item on which a larger gross margin is realized. This type of selling, while common among certain discount houses, is by no means peculiar to them. It is merely a form of "bait" advertising widely used by the less scrupulous operators in many retail fields including automobiles, furniture, storm windows, jewelry, and photographic studios.

Conclusion. It is unquestioned that discount houses have had a substantial influence upon modern retailing. The degree to which their success may be attributed properly to lower costs of doing business or to discriminatory concessions, fictitious list prices, and deceptive selling practices is a matter that has been vigorously debated and one which is not likely to be soon resolved. In many metropolitan areas, they have succeeded in obtaining a substantial share of the total market for consumer durable goods and there is little doubt that the lower prices which they have offered played a major role in the attainment of their competitive position.

In the late 1940's and the early 1950's, discount operators were commonly referred to as parasites, bootleggers, or described in even more uncomplimentary terms. In the period 1954–56, they had attained a sem-

[20] Arnold Corbin, "Economics of Discount Selling," in *Changing Patterns in Retailing* (Homewood, Ill.: Richard D. Irwin, Inc., 1956), pp. 129–30.

[21] George Webster, "Changing Distribution Concepts," copy of an address delivered at the Second Institute of Management for Appliance-TV Dealers on the campus of American University, August 14, 1956, pp. 9–10.

blance of more general respectability. Goaded by the success of some discount houses, other retailers have been forced to reconsider their position, to enter into more forceful and dynamic selling methods to stimulate people to buy, and to pare selling and other operating costs to meet such price competition.

The character of discount houses has also changed somewhat. Many of the earlier types offered only extremely limited assortments of merchandise, often of a distress character or of discontinued models; sold from very poor physical facilities; provided practically no customer services; and were generally held in low esteem, even by many of their patrons. In order to reach a wider market, many of them have had to seek better locations; enlarge or modernize their facilities; and add various kinds of widely demanded services such as installation, repair, delivery, and instalment credit facilities.[22] Their success in winning customer patronage made them more desirable outlets, with the result that they are actively sought as customers by some major brand name manufacturers. As a consequence of these factors, the larger discount houses have become more or less accepted as a limited-service type of departmentized store with well-established relationships with regular sources of supply for practically all classes of merchandise that they choose to handle. At the same time, many of their competitors who have adapted their operations to compete more effectively have made it difficult to distinguish clearly between discount houses and other price-appeal stores.

A major effect of discount house competition has been an expansion in the market for many kinds of goods formerly sold selectively to limited segments of the market. And it appears probable that a permanently lower level of gross margins on durable goods has been brought about as a result of the pressures from this type of competition. The manner in which this is related to resale price maintenance policies of manufacturers is discussed in Chapter 34.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   a) supermarket
   b) superette
   c) trading stamps
   d) planned shopping center
   e) neighborhood center
   f) community center
   g) regional center
   h) discount selling
   i) discount house
2. Explain each of the main elements of supermarket merchandising strategy.

[22] William R. Davidson, "Retailing—Some Significant Current Developments," *The Appraisal Journal*, January, 1957, pp. 93–94. For an empirical study of discount house services, see Claire M. Gross, "Services Offered by Discount Houses in Metropolitan New York," *Journal of Retailing*, Spring, 1956, pp. 1 ff.

3. What dynamic adaptations have been associated with the supermarket industry in the 1950's?

4. How do the operating expense ratios of contemporary supermarkets compare with those of the earliest institutions of this kind? How can the difference be explained?

5. The first supermarkets were operated by independent merchants. How do you account for the fact that most supermarkets today are units of chain store organizations?

6. Assume that the Bureau of the Census has decided to make an enumeration of all supermarkets in the country and that you have been employed as a consulting expert to formulate a definition for classification purposes. How would you define a supermarket? Keep in mind that your definition must provide for meaningful distinctions between this and other kinds of stores, that it must be generally in line with established concepts, and that it must serve as a satisfactory guide that will be interpreted uniformly by enumerators working in all sections of the country. Would you include a requirement for some minimum annual sales volume? Can you see any reason why such a requirement might be very undesirable?

7. A supermarket, independently owned, has been operating successfully on a very close margin. Nationally advertised brands are carried exclusively in the dry grocery departments. The manager is approached by a large local wholesaler who wishes to stock these departments with private brands on which a much better margin can be secured. What should the manager do? Would your answer be different if this store were a unit of a chain of such supermarkets? Explain.

8. What are the distinguishing characteristics of planned shopping centers?

9. What environmental factors explain the rapid development of planned shopping centers since 1945?

10. Why have certain large retailing organizations gone into the business of developing planned shopping centers? What other kinds of ownership interests are associated with such developments?

11. During the period 1948–1956 various estimates of the volume of business done by discount houses have been published in generally reputable sources. These estimates have varied widely even for a given year. How can this be explained?

12. Cite as many examples as you can of "discount selling" by so-called regular retailers.

13. How is it possible for one retailer to operate at a lower net profit, as a per cent of sales, than another in the same line of business, but still realize a much higher net profit, when measured as a per cent of invested capital?

14. What are the bases for the price appeal of the discount house?

15. In an advertisement, a discount house featured a large illustration of a kitchen range. Below the picture this statement appeared in very bold type: "Regular price, $199.95—Our Price, $99.95—Save $100." Is it possible for a discount house to offer such an item at this kind of a saving? If you visited the store to purchase this item, what kind of salesmanship might you expect? Explain.

12

NONSTORE RETAILING

In the preceding chapters of Part III the discussion has been concerned with retail *stores,* defined in Chapter 7 as retail establishments which are open to and frequented by the general consuming public. A small but significant proportion of the total retail trade in the United States is accounted for by *nonstore* retail *establishments.* These are distinguished from stores by the fact that the customer does not make his purchases at the establishment; instead, the purchase is made at the home of the customer, at the site of some other business place, or by use of mail or telephone for the placement of orders.

The three principal types of nonstore establishments include mail order houses, house-to-house selling organizations, and operators of vending machines. In 1954 such nonstore retailers operated 78,508 establishments which came within the scope of Census of Business coverage and these accounted for 2.7 per cent of the total sales volume of all retail establishments. Each of these methods of retail selling is of greater importance than indicated by Census data, because some manufacturers and agricultural producers utilize such techniques to some degree in selling to consumers directly from factories or farms.

Mail Order and Catalog Retailing

The number of retail concerns operating exclusively on a mail order basis is relatively small, but this method of operation is sufficiently widespread in retailing to justify detailed consideration. Moreover, it represents a distinctive way of doing business and illustrates the effect of changing conditions upon retailing institutions.

Types of Organizations. Four distinct types of organizations sell by mail. The most important are the general merchandise mail order houses which

sell a great variety of consumer and farmer goods, carrying in stock many more items than are sold by any department store. Such companies are primarily retail institutions. They purchase the majority of their goods from manufacturers, although the two big companies which dominate this field—Sears, Roebuck & Company and Montgomery Ward & Company—both with Chicago headquarters, sell a great many articles manufactured in plants which they own or actually operate. In addition to the two large companies of this type there are several smaller concerns, carrying a somewhat more restricted variety of merchandise, but which can still be considered general merchandise mail order concerns.

The second type consists of firms which sell one or more special lines of merchandise. Several examples are found in the women's apparel industry, where a number of companies have built up a very large business. In some cases dry goods and notions are carried by companies primarily concerned with the sale of wearing apparel. Several companies specialize in the sale of automobile tires and accessories, and others are found in jewelry, cigars, shoes, furniture, etc. Such companies are retailers rather than manufacturers, for their *form* production activities are relatively unimportant.

Manufacturers who sell by mail constitute the third type of mail order institution. Some such producers have found that their particular products can be sold directly to the consumer by mail without the use of wholesalers or retailers. The fourth type of mail order retailing is carried on by certain department and other large stores which accept orders by mail. Primarily confined to orders for merchandise currently advertised, this type of selling is a supplement to the receipt of orders over the telephone.

History of Mail Order Retailing. Mail order selling arose in a number of different ways. Montgomery Ward & Company was founded in 1872 by a former retail clerk in Chicago who had also had experience as a traveling salesman. The Patrons of Husbandry, commonly known as the Grange, had established a number of retail cooperative stores and needed a wholesale connection. Mr. Ward saw the opportunity and started the business which still bears his name. But the Grange stores were not generally successful and Mr. Ward's business was expanded into a mail order house to take advantage of the good will which was attached to the firm name by the former members of the cooperative stores.

Sears, Roebuck & Company, the largest mail order house, grew out of the efforts of Mr. Sears, a small-town station agent in Minnesota, to sell watches which had been shipped to his station on approval but rejected. He saw the field for a mail order business and started a watch and jewelry mail order house in Minneapolis which was later moved to Chicago. The present large-scale enterprise has grown from this small part.[1]

[1] An interesting and scholarly treatment of the origin, development, and present operation of Sears, Roebuck & Company, encompassing both mail order business and

Other general mail order houses had varied beginnings. Many have expanded from ordinary retail stores. Others started as specialty houses and gradually expanded until they handled a more general line of merchandise. Many of the specialty houses were founded by businessmen who realized the opportunities for such a method of selling. The manufacturers who sell by mail have adopted that plan as a rule only after careful consideration of the various methods of distribution that might be available to them.

Probably the most important reason for the success of the mail order houses in the early stages of their development is to be found in the failure of country merchants to meet changing demands for merchandise. At that time the country general store with all its inefficiencies was the dominant type of retailing. Throughout the West and South, farmers and residents of the smaller towns were able to raise their standard of living after the period of reconstruction. Income from the farms, especially in the form of cash, became larger. Farmers became interested in some of the comforts enjoyed by city people. But the country and small town merchants did not realize that a change was taking place. They continued to confine their stocks to staple and conservative style merchandise which had been sold for many years. In fact, even had these merchants realized the changed demands of the trade, the limitation imposed upon them by small, local markets would have prevented their offering as wide and varied a range of goods as that sold by mail order houses with their wider markets.

Thus the prevalence of an essentially inefficient type of retailing made it possible for the mail order houses to make significant inroads into the retail business of the rural areas. The other important factor that made mail order business possible was the development of adequate rail transportation. This type of transportation expanded exceedingly fast in the decade following the close of the Civil War. For the first time it became possible to place orders by mail and to deliver merchandise to scattered areas at a reasonable cost and at relatively certain dates.

The spectacular and consistent development of mail order retailing began, however, with the establishment of rural free delivery service. Farmers as a class began to subscribe for city daily papers. They were thus reached by style news and by information on various changing methods of life which before had come to their attention only indirectly. Later, the moving pictures and the rotogravure supplements of the newspapers exercised their effect in creating demand for many articles not previously included in the standard of living of farmers and residents of the smaller towns. Mail order retailing offered an opportunity for the purchase of these goods. Developments in catalog making made it possible to advertise these goods effectively and to supply realistic photographs or drawings. Establishment of the parcel

retail store operation, is available in Boris Emmett and John D. Jeuck, *Catalogs and Counters* (Chicago: University of Chicago Press, 1950).

post system in 1913 made it possible to ship small packages more economically than under freight shipment. A final factor in the growth of mail order houses was the recognition that this method of selling could take advantage of the economies of large-scale retailing.

The larger mail order companies engaged in programs of diversification as the country became more urbanized and opened many retail establishments of the department store type. Such stores now account for the majority of the business of both Sears' and Ward's, but mail order or catalog retailing continues to be a very large segment of their total sales volume.

Present Status of Mail Order Establishments. In 1954 there were 2,019 retail mail order establishments, of which 1,301 had paid employees and 718 were very small units operated exclusively by proprietors and members of their own families. The aggregate sales volume of all of these establishments amounted to $1.6 billions, or about one per cent of the total sales volume of all retail establishments. There has been practically no change in the relative sales volume importance of mail order establishments over the period 1929–1954.

While the 2,019 mail order establishments operated in many lines of retail trade, more than 77 per cent of their sales was reported by only 33 large establishments handling a complete line of department store merchandise. Of these, 20 were establishments operated by only two companies —Sears' and Ward's.[2] Thus, it is apparent that a very great proportion of the total business of mail order houses is concentrated in the two leading organizations in this field.

Competitive Position of General Mail Order Houses. The general merchandise mail order organizations have, in the main, the advantages and disadvantages of other large-scale retail enterprises. There are, however, certain special conditions, due to the peculiar nature of their business, which affect favorably their competitive situation.

Advantages. As compared with both single-line and general stores in the rural districts, mail order houses offer a more complete and varied line of merchandise. Their location in the larger cities gives a certain amount of prestige to their merchandise, especially in style goods. It is alleged that prices, at least for many articles, are somewhat lower than those charged for corresponding articles in the rural communities. Buying from a catalog is perhaps quicker and easier for rural people than going to stores in somewhat distant cities, and such shopping can be done at any time of day or evening that is most convenient. Absence of pressure to buy, avoidance of

[2] In the Sears, Roebuck & Co. *Annual Report—1955,* the company reported the operation of 11 mail order houses in the United States. In the Montgomery Ward & Company *Annual Report—1955,* this company was reported to be operating 9 such establishments.

the confusion of crowded stores, informative statements concerning products, guaranties, and a liberal returned-goods policy are other things that appeal to many urban as well as rural area consumers. Because sales are made in all sections of the country and appeals are made to different classes of consumers, sales are not greatly affected by local industrial depressions, as are those of local merchants.

Some general advantages enjoyed by all mail order vendors grow out of certain operating economies. Their warehouses are located in parts of the city where rent is much lower than that which must be paid by the ordinary retailer. Expensive fixtures are unnecessary, for only equipment of the warehouse type is required. It is unnecessary to employ retail salespeople, for the catalog descriptions plus the reputation of the house, price appeals, etc., effect sales. Hence employees of the clerical and shipping department type are used and their work is scheduled to permit an efficient utilization of time—something difficult to accomplish in retail stores which must be staffed in accordance with daily and hourly variations in consumer traffic. As compared with the ordinary service store, mail order houses have the advantage of doing a cash business on most of their sales.

Disadvantages. There is little doubt that selling by mail has a disadvantage growing out of the impossibility of examining merchandise in advance of purchase. For such commodities as shoes, gloves, and clothing, it may be difficult for the buyer to secure the right articles without trying them on for size and fit. Many consumers hesitate to order by mail any products where size, color, style, texture, or becomingness are significant in choice making. Purchase by mail requires from two or three days to a week or more to secure delivery, hence advance planning and patience are prerequisite.

An extremely important limitation is the inflexibility of the merchandising program. The catalogs published by Sears' and Ward's comprise between 1,000 and 2,000 pages. Plans must be made well in advance of the season as to the detailed composition of the line of goods and the manner in which they are to be featured and illustrated. More important, prices must be determined many months before catalogs are distributed to consumers, and the firm usually must live with its pricing decisions throughout the six-month catalog season. While the catalogs contain statements that prices are subject to change without notice, and even though special sale catalogs are sometimes issued, the companies do not have the pricing flexibility accompanying the other forms of store organizations. They cannot mark down individual items of merchandise as the rate of sale becomes too slow or as costs decline; neither can they raise prices on individual items as demand increases or as wholesale costs rise. New items can be added only at the time that new catalogs are being prepared, and items can be dropped

from the currently publicized offering only at the risk of creating ill will among customers.

Methods and Policies of General Catalog Houses. Certain, and in some cases distinctive, methods and policies have been adopted by the general catalog houses—in large measure for the purpose of capitalizing upon their competitive advantages or in order to minimize the limitations associated with this method of doing business. Sales promotional activities are thoroughly and efficiently organized. Mailing lists are prepared with some care and efforts are made to keep them up to date. Careful tests are made of the success of different types of copy and appeals. Experienced copy writers know the language and the appeals which are most useful in reaching their clientele.

Buying by mail is slower, obviously, than buying from local suppliers. In order to overcome this disadvantage, well-distributed branch or regional warehouses are operated to serve consumers in different parts of the country. As a result of very efficient order-filling systems, most orders are shipped the day they are received, and special provisions are made to eliminate delay in delivery as much as possible.

In order to overcome the reluctance of buyers to purchase articles which they cannot see before the order is placed, mail order houses give a very liberal guaranty, covering as a rule both quality and price. If the purchaser is dissatisfied with the commodity, it may be returned at the expense of the seller, and the purchase price is promptly refunded. No doubt many unjustifiable returns are made, but the policy is warranted by the amount of good will which is built up and by the encouragement to purchase to which it gives rise.

The general catalog houses have a special brand problem. To attract business, as they do in part, on a price-appeal basis, they must be able to purchase from the suppliers who quote the lowest prices. For this reason such houses do not generally carry very many nationally advertised, branded articles. Rather do they prefer to sell unbranded commodities or those which carry their own brand. It is usually necessary to brand the specialties which they sell, in order to identify them and give them a certain distinction. Hence it is common for catalog houses to purchase such articles as vacuum sweepers, gasoline engines, washing machines, farm implements, cosmetics and drugs from suppliers who attach to the goods the private brand of the mail order house.

In order to reach a larger number of potential customers, the major firms have opened a large number of catalog order offices which are located in storerooms in hundreds of small cities and in many suburban shopping centers of large cities. No merchandise is available for sale over the counter in these establishments, but selected items and swatch and sample books

are displayed for examination. Employees assist customers to make out and transmit orders, thus saving them money order fees and postal inconveniences. Customers can save on shipping charges and delivery time by picking up their orders at such establishments, because orders are shipped in bulk from mail order warehouses to such locations. Similar catalog departments are also found in the larger retail stores operated by the mail order companies.

Another feature is the operation of telephone order offices. While confined to larger cities in which there is a considerable potential volume of daily business, this development is one which may be of greatly increasing significance. In cities where the service is available, customers may telephone orders into local offices. The orders are then teletyped to the nearest branch warehouse of the company and filled. All orders going to a particular city are grouped for fast overnight shipment and are available for local delivery in the originating city within a day or in two days. In this manner, the catalog can compete effectively with local department stores for telephone-delivery business.

Mail Order Selling by Limited-Line Retailers and by Manufacturers. The mail order method of selling is used to some extent by retailing organizations that distribute a limited line of goods and by certain manufacturers who sell direct to the consumer. The method is also used in the direct marketing of some consumer farm products with a special appeal, such as Smoked Virginia Hams, honey, smoked turkeys, and gift packages of fruit.

Such sellers usually do not have elaborate catalogs, but secure orders by advertising in newspapers and magazines, on radio and television broadcasts, and by direct mail addressed to the homes of consumers. Goods so ordered are shipped by parcel post, express, truck, or ordinary freight.

One reason for this type of selling is that it affords an opportunity to bring many kinds of goods to the attention of a broad market. Items sold in this manner are often of a novel or unusual character and are not available in local retail stores, especially in smaller communities. Some merchandise is sold direct to consumers by manufacturers who stress a price appeal. While mail order retailing is relatively expensive, since it usually involves substantial advertising and handling and shipping costs, many consumers are nevertheless influenced by an appeal which suggests that they save money by purchasing direct rather than from a retail store.

Appeals of "lower prices," "greater values," or "substantial savings," have been used by most of the major book club companies that have a membership which is contacted by mail. Such savings are customarily offered in terms of "free" or "bonus" books, awarded when the member actually purchases a predetermined number of books at regular prices, in accordance with a membership agreement. Bonuses offered in this manner

are due in large measure to the low purchase prices that such clubs are able to negotiate with publishers when contracting for large numbers of copies and not to economies of selling and distributing to individual consumers on a mail order basis.

Manufacturers and retailers who sell a narrow line of goods by the mail order method are subject to most of the disadvantages enumerated above in connection with general mail order houses. In addition, they usually lack the prestige enjoyed by a large, nationally known retailing organization. Hence, such selling is relatively unimportant in the total retail trade structure, and there are no reasons to believe that it will ever be of much significance in other than a very narrow range of merchandise items.

House-to-House Retailing

Types of "House-to-House" Selling. According to common usage, the term "house-to-house" selling includes almost any type of retailing that involves contacting the consumer at his residence rather than in a retail store. Several principal forms of this kind of selling may be readily distinguished. First, there are a number of manufacturing companies and retailers who actually canvass consumers on a house-to-house basis. Often no attempt is made to canvass market areas completely, but solicitation is confined to residential areas or types of families which, in the experience of the individual company, have proved the most fruitful source of business. In some cases, sales coverage is haphazard because solicitation is confined largely to friends, neighbors, or other individuals who have personal contacts with the salespeople of a "house-to-house" selling organization. House-to-house salesmen in some instances are employees of the manufacturer who uses this method of direct distribution; in other cases they may be independent dealers who buy merchandise from the manufacturer and resell as merchant middlemen. Some of these independent nonstore dealers handle the products of several organizations.

Second, some companies use what is known as the "party plan." Salesmen arrange to have a housewife give a party in her home, at which the merchandise of the selling organization is demonstrated to a group of the hostess' friends. The person holding the party receives merchandise prizes, awarded on the basis of the amount of merchandise purchased by those attending her party and, in some cases, also on the basis of the number of those attending who agree to serve as hostesses for similar parties. A variation of this method is a "club" plan, according to which a consumer is awarded prizes or granted discount buying privileges by getting new customers to join the "club." The "club," of course, is the group of customers served by the selling organization and one joins by making purchases. These approaches involve something of the chain letter technique, in that each

new customer is expected to obtain a number of additional new customers for the company.

Third, many companies sell to the consumer at his home on the basis of advance prospecting information. Home calls may be preceded by telephone solicitation in which women with pleasing telephone personalities are employed to call large numbers of consumers. Names of those who manifest some degree of interest are turned over to skilled salesmen who call on the consumer at home. Prospect information is also obtained in response to offers made in newspaper, car card, or other forms of advertising.

One or more of the above forms of selling are used by a large number of well-known manufacturing or distributing companies including Avon Products, Inc. (cosmetics), Beauty Counselors, Inc. (cosmetics), Electrolux Corporation (vacuum cleaners), Fashion Frocks, Inc. (women's apparel), Fuller Brush Company (brushes, cosmetics, and household items), The Process Company (greeting cards), Real Silk Hosiery Mills Inc. (hosiery and apparel), and Stanley Home Products, Inc. (brushes and household cleaning aids). Such methods are also widely used on a national basis in selling reference books, encyclopedias, and magazine subscriptions. Some local retailers and small manufacturers use the same approaches in selling a wide range of items, especially in the home furnishings or home improvement categories.

A fourth method coming within the general coverage of "house-to-house" selling consists of route delivery service of perishable food items. A large proportion of the milk sold for home consumption is delivered to the consumer's home by a driver-salesman. In most cities there are baking companies (e.g., Omar, Inc.) that sell direct to consumers through route salesmen. Since this method involves frequent and continuing contacts with regular customers who are purchasing perishable food items in this manner, largely because of convenience, it is somewhat apart from the other methods enumerated above. Most of the discussion in the remainder of this section is only partially applicable to the operations of such "route companies."

Importance of House-to-House Selling. House-to-house selling is the most important form of nonstore retailing. In 1954, more than 70,000 establishments were enumerated in the Census of Business classification, "Direct Selling (house-to-house) Organizations," and they accounted for about $2.3 billions of sales, or 1.3 per cent of the total for all retail establishments. This is believed to be less than one-half of the volume of retail sales made by this method, because the Census does not enumerate as house-to-house organizations those companies which operate a house-to-house salesforce out of a manufacturing, wholesaling, or service establishment whose principal activity is something other than retail trade in tangible

commodities.[3] Nor does it include the house-to-house selling activities of regular retail stores that use it to some extent to supplement the selling effort of retail store employees.

Reasons for House-to-House Selling. Manufacturers and retailers that use house-to-house selling do so primarily because of their ability to build a large volume of business through concentrated and specialized personal selling techniques. Trained in the art of high-pressure salesmanship, the house-to-house man gets results whether it be a "two for a quarter" item or an air-conditioning plant involving several hundred dollars. If the salesman can interest the consumer in the real or imagined qualities of his offering and can, by carefully planned selling phrases, suggest that nothing like it can be had locally or that its price is very attractive, the sale is a natural outcome.

Manufacturers are interested in house-to-house distribution in some cases because of the attractive margin which is available but more often because they can get volume only by this method. If several hundred salesmen can be recruited, trained, and assigned to territories and if the product is worthy, sales may be expected. The problem of interesting wholesalers or retailers in stocking the product and of getting their salesmen to present it to buyers through displays or face-to-face selling is avoided. It is not necessary to use extensive advertising to force sales, for personal sales effort is substituted for advertising except in the case of a very few large firms who sell in all parts of the country and have found that advertising helps the salesman to gain admission and to secure an audience. Another advantage is that both the activity and the message of the salesman can be controlled and directed. In no other way could a manufacturer of aluminum ware or hosiery secure the full-time efforts of several hundred salesmen devoted to selling a single line of products. Thus volume sufficient to operate factories on an economical basis and in part offset heavy sales costs can be secured.

House-to-house selling is attractive to some organizations because sales costs are flexible, varying directly with variations in volume. Salesmen are compensated, in the great majority of cases, altogether on the basis of commissions. Thus there is no expense for personal selling except for sales actually made. By way of contrast, companies that distribute through orthodox channels, or that operate regular retail stores, usually must pay salaries in addition to incentives, provide for travel expenses, and incur other ex-

[3] Independent estimates of the amount of business accounted for by house-to-house organizations have ranged, for 1953 or 1954, from a low of about $1 billion to a high of about $10 billions, explained in large measure by differences in the scope of coverage. Lower estimates are confined to consumer goods manufacturers who distribute primarily through a direct selling salesforce, whereas higher figures include house-to-house sales by regular retail stores, insurance companies, service organizations, and even such extremes as Girl Scout house-to-house cookie and candy sales. For a variety of such estimates see Victor P. Buell, "Door-to-Door Selling," *Harvard Business Review,* May–June, 1954, pp. 114–15.

penses which tend to make selling costs considerably higher in times of declining sales volume.

Limitations and Disadvantages. Lack of consumer confidence in the seller, his firm, and his product is an important limitation to house-to-house selling. There are just enough fraudulent schemes to cause careful buyers to be wary. Better Business Bureaus have done much to limit the work of fraudulent sellers and in doing so have assisted legitimate firms.

When house-to-house salesmen call at frequent intervals the inconvenience of answering doorbells and of taking time from household tasks to listen to the sales presentation of the salesman reacts to the disadvantage of this method of selling. To overcome the reluctance of housewives even to answer the doorbell, some of the larger companies have adopted a variety of plans to pave the way for calls. One common strategy is that of leaving a card saying that the salesman will return at a stated time with a small but useful gift. Another is that of leaving an attractive catalog at the housewife's door a day or two in advance of the salesman's visit. But in spite of all these plans, house-to-house selling is self-limiting because it can grow only at the expense of increasing demands upon the time of the consumer.

Another disadvantage consists of the sales management problem of recruiting, training, and supervising large numbers of salesmen or so-called agents. Usually they are of the type who need constant stimulation and close supervision, and contacts with them must be maintained frequently. When the sale is by description only or even by sample, the salesman is handicapped, for many buyers have a definite preference for goods which can be inspected at a local store. Moreover, when an order is given to a canvasser, demand must be anticipated or sufficient interest must be created to last until the delivery can be made some days later. Often the desire for the article has cooled by that time, and the order is rejected, even at the cost of forfeiting the partial payment made to the salesman.

Finally, many cities have enacted ordinances regulating or forbidding house-to-house selling, canvassing, or soliciting of business, and thus protecting local merchants from this type of competition. The first such ordinance, which forbade this type of selling or business solicitation, except with the permission or upon the invitation of the householder, was enacted in Green River, Wyoming, in 1933; hence all comparable enactments by municipalities have become known as "Green River" ordinances. The constitutionality of these city laws has been bitterly contested by injured businessmen on the ground that they place undue restrictions on personal freedom in choosing a method of distribution and are a restraint on "the right to engage in one of the common occupations of life." But in a decision handed down by the United States Supreme Court on June 4, 1951,[4] such ordinances were ruled

[4] *Frank H. Breard v. City of Alexandria, La.*, U. S. Supreme Court *Reports,* No. 399, October Term, 1950 (341 U.S. 622).

to be valid and constitutional, so that a municipality may now regulate or ban altogether any door-to-door selling or canvassing if it so desires. This decision prompted a number of additional communities to adopt similar laws. For the most part, however, they have been enacted in small towns and suburban communities near major metropolitan areas. While constituting a problem, the coverage of such laws has not been sufficiently widespread to limit materially the quantitative significance of house-to-house selling on a national basis.

Undoubtedly the most important limitation is the high cost of this method of distribution. Some consumers believe that they save by buying from house-to-house salesmen, especially when dealing with a manufacturer's salesman or agent. Experience has proved, however, that direct selling manufacturers do not eliminate any of the retail middleman's functions but, in fact, usually incur higher costs than manufacturers who distribute through normal channels. Commissions paid to house-to-house salesmen are within the range of about 20 to 40 per cent for most commodities sold in this manner and are often higher than the total gross margin realized by retailers handling similar commodities in regular stores. In addition, high costs of shipment or delivery are incurred on items of low unit value. Unless the consumer pays in advance, there are c.o.d. ("collect-on-delivery") charges to be considered. Even among regular retailers who use house-to-house selling as a supplement to store selling, as is often done in the furniture and appliance trades, commissions paid to "outside" salesmen are usually about twice as large as those paid to salesmen who work in the store.

Because of the various problems and limitations involved in this method of distribution, it is not likely that it will ever become a larger part of total retail trade. The method is confined largely to types of items where sales volume can be expanded greatly by highly concentrated personal selling effort and to situations in which an unusually wide gross margin may be obtained so that the high costs of this method of distribution can be covered.

Vending Machines

Distribution of goods through automatic vending machines is a third distinctive form of nonstore retailing. By vending is meant the selling of goods through an automatic machine which releases an item of merchandise upon insertion of a coin or coins by the consumer, thus completing the transaction without the aid of a salesperson.

Historical Development. Crude forms of vending machines were in operation in Europe and in the United States in the nineteenth century. Early machines were restricted largely to the sale of candy, nuts, gum, tobacco products, and postage stamps. During the early part of the twentieth century,

there was a great expansion in the United States in bulk vending (i.e., machines which measure out a portion of some unpackaged items such as nuts or candy), especially, "penny sale" machines. In the late 1920's and in the 1930's, new types of machines were designed to vend five-cent confections, bottled soft drinks, and packages of cigarettes. The development of cigarette vending machines and their acceptance by the consuming public is widely heralded as the inception of the modern era of automatic merchandising. Cigarettes were the first class of commodities retailing for more than five cents and sold on a wide basis through vending machines.

Present Status of the Industry. Outside of the tobacco, soft drink, and candy trades, vending did not attract much attention until after the middle 1940's, when experimental attempts were made to merchandise a wide variety of merchandise items on an automatic basis, some of which proved relatively successful. In 1954, according to the Census of Business, there were some 5,715 "merchandise vending machine operators," with sales of $636 millions, or about 0.4 per cent of the sales of all retail establishments. These are middlemen who specialize in the operation of vending machines that primarily dispense merchandise rather than provide services.[5]

Trade estimates indicate that the total volume of vending machine sales is much greater than reported by the Census. In 1955, two different sources reported total vending merchandise sales of about $1.7 billions.[6] Differences between Census data and the estimates made by the trade are explained by three major factors. First, some wholesalers operate retail vending machines as an adjunct to their wholesaling business. This is especially significant in the case of retail cigarette vending by tobacco jobbers. Second, many machines are owned or are serviced by local processors or manufacturers. Bottled soft drinks, ice, and milk are among the commodities often distributed through vending machines by the producer of the commodity rather than by a vending machine middleman. Third, many vending machines are owned and serviced by very small operators who engage in this activity only as a sideline and thus do not meet Census requirements for classification as a business establishment within the vending machine trade.

While vending machines account for only a small part of total retail trade, they are extremely important in the sale of certain commodities. Of total vending machine merchandise sales, about 43 per cent consists of sales

[5] There are no reliable market data available on the number or sales volume significance of "service vending machines." Among the classes of services commonly available by means of a self-service, coin-operated device, are cleaning, coin changing, clothes drying, ironing, massage equipment, music, parcel lockers, photograph machines, restroom facilities, scales, shoe shiners, telescopes, tickets, travel insurance, typewriters, voice recorders, and washing machines.

[6] *1956 Directory of Automatic Merchandising* (Chicago: National Automatic Merchandising Association, 1956), pp. 16–17. Also, "1956 Market Data" issue of *Vend* magazine, p. 2.

of cigarettes, about 33 per cent of cold and hot bottled and cup drinks, and about 15 per cent of candy and gum. All other products collectively constituted less than 10 per cent of the total vending machine market in 1955.[7]

Vending Machine Operators. The vending machine firm is a rather distinctive form of retailing enterprise in that its business operations are carried on in locations owned by other retailers or by other kinds of businesses or institutions. While there are a few large vending firms, it is predominantly a field of small operators. Many are strictly family businesses, and most of the others have only a few employees.

Like other retailers, the vending machine operator buys merchandise and maintains an inventory. Even though most firms are small and deal only in convenience items, it is common for them to purchase direct from manufacturers rather than from wholesalers. Their business is so specialized by merchandise lines that direct buying arrangements are often feasible and economical.

Vending machine locations are organized into routes which are served on schedule. At regular times, route men clean the machines, replenish the inventory, remove and audit sales receipts, and make any minor adjustments that may be necessary. Some operators have specialized service men to handle emergency calls to restore inoperative units whenever a mechanical failure occurs.

A major and distinctive problem of the operator is that of soliciting location-owners to obtain the right to place a vending machine on their premises. One type of location consists of regular retail stores, which use vending machines as a supplement to their personal selling service. Other locations include almost any kind of site at which a large number of people congregate or pass by with regularity. Examples of the more desirable types of nonstore locations include airports, amusement centers, apartment buildings, armed service installations, bus terminals, hospitals, industrial plants, office buildings, railroad stations, turnpike restaurants and service stations, schools, and theater lobbies.

Machines are sometimes sold or leased to the owner of the location but it is much more common for the vending machine operator to retain ownership of the machine and pay the location-owner a rental fee, usually determined as a percentage commission or a specified amount per unit of product sold. While there is great variation in rental fees, the average for all commodities is about eight per cent of vending machine sales.[8] Thus, to a considerable degree, the usual operational arrangement is analogous to that of a leased department.

[7] Calculated from data for merchandise sales through vending machines in *1956 Directory of Automatic Merchandising, op. cit.*

[8] G. R. Schreiber, *Automatic Selling* (New York: John Wiley & Sons, Inc., 1954), p. 86.

Evaluation of Vending Machines as a Form of Retailing. Vending machines are used, in some instances, in regular retail stores where retailers wish to avoid "nuisance problems" connected with certain kinds of goods. Soft drink, candy, and cigarette sales are usually of low unit value and therefore relatively expensive to process by personal selling effort. Also, such items are often pilfered by customers or are consumed by store employees who do not bother to pay for them, with resulting inventory loss. Such problems are often avoided by leasing space to a vending machine operator and substituting the machine for orthodox retailing.

Vending machines have had the effect of enlarging the opportunity for marketing many items by offering them for sale at places where, and at times when, it would not be feasible to provide regular store selling service. Many items sold through vending machines are purchased for immediate consumption; hence, the production and use of such items in the quantities in which they are marketed is to a substantial measure dependent upon the vending machine as a distribution method. In recent years, there has been a tendency to sell through vending machines more items in the so-called "take-home" market. Ice, ice cream, and milk are items which have been vended profitably in many cities from nonstore locations which are accessible to the consuming public twenty-four hours a day, seven days a week.

One of the most rapidly growing markets for vended products consists of industrial plants where increasing interest has been devoted to machines as dispensers of foods. In some factories, vending machines supplement regular cafeteria food service by providing hot and cold beverages, sandwiches, and desserts, at a variety of in-plant locations. In many small plants that cannot provide regular in-plant food service, the vending machine has become an attractive supplement to the traditional lunch-pail.

The vending industry experienced a very favorable rate of sales growth in the period subsequent to World War II—a factor which has stimulated much discussion about this method of distribution, and one which has prompted all sorts of judgments as to the future of this form of retailing. When careful consideration is given to the characteristics of vending machines and to the products which have been marketed through them on any appreciable scale, it is readily apparent that this method of selling is self-limiting.[9] First, vending machines are dependent upon the use of coins, which factor effectively limits them to sales of merchandise of low unit value. While some vending machines have been developed to dispense merchandise at prices up to about $5, volume sales are limited practically by amounts of change carried by the ordinary consumer.

[9] For a detailed and scholarly evaluation of limitations of vending, see Martin V. Marshall, *Automatic Merchandising* (Boston: Harvard University Graduate School of Business Administration, 1954), chap. xii. This book also provides a detailed account of various experiments in food service vending and vending of various classes of goods by department stores.

Second, notable success has been achieved with vending machines only in the case of products possessing certain accepted "vending characteristics." These include small size, great frequency of purchase by the average consumer, and purchase on a strictly convenience basis. Attempts to merchandise shopping goods through vending machines have not been successful, except in highly specialized situations.

Third, even though vending machine sales are effected without the aid of a retail salesperson, vending is still a relatively expensive form of distribution. It can be carried on profitably only at locations where a reasonable volume of regular sales can be expected. The machines in common use involve substantial investments of capital, which must be recovered by adequate depreciation charges. Servicing of the machines by route men is time-consuming and costly. In addition, the vending machine operator must cover the overhead costs of his business and pay the location-owner a fairly substantial proportion of the total receipts for rent. Vending could not have attained its present state of development if consumers were not willing, at least in many cases, to pay some premium over regular retail store prices for the added convenience of buying at nonstore locations and at odd hours through the facilities thus provided.

In summary, it is apparent that vending is a relatively high-cost method of distribution; that gross margins on goods vended must ordinarily be higher than on goods sold in large volume through ordinary retail store methods; and that vending is limited substantially to convenience goods items which may be purchased by the consumer at almost any place without advance planning. Vending is likely to remain a small factor in the total retail sales picture, but it will probably play a greater role within the framework of the limiting factors just enumerated.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   - *a*) nonstore retailing
   - *b*) nonstore retail establishment
   - *c*) house-to-house retailing
   - *d*) "party-plan" selling
   - *e*) "club plan" selling
   - *f*) Green River ordinances
   - *g*) automatic vending
   - *h*) vending machine operator
2. How important are nonstore retail establishments? In view of their limited quantitative significance, how can you account for the fact that an entire chapter in a basic marketing text is devoted to a discussion of nonstore methods of selling?
3. To what degree is the sales volume of mail order establishments concentrated in a few companies?
4. What is the difference in the competitive position of general mail order companies and that of specialty retailers or manufacturers that sell to the ultimate consumer by mail?

5. How does the management problem of pricing in large general merchandise mail order establishments differ from that of regular store retailers?

6. Select two or three items in a Sears, Roebuck or Montgomery Ward catalog and note their prices. Then visit one of the stores of the company in question and attempt to purchase the identical items directly from the store. Are the prices of these items likely to be the same whether purchased by mail or from the store? If not, which price is likely to be higher, and for what reason?

7. During the mid-1950's, various estimates were published indicating the volume of business done by house-to-house selling. These estimates have varied from a low of about $1 billion to a high of about $10 billions of annual sales volume. How can you account for such a wide range in estimates?

8. What are the principal reasons that account for the use of house-to-house selling on the part of certain well-known manufacturing companies? What limiting factors keep most manufacturers of consumer goods from selling in this manner? Explain.

9. A manufacturer of apparel items employs house-to-house salesmen who use the following sales argument: "Buy direct from the factory and save all middlemen costs. Retailers and wholesalers do not get a rake-off on the merchandise bought from our company." Evaluate this line of reasoning.

10. John Jones is a midwestern farmer living on a good road within 40 miles of Cleveland. On his 60-acre farm he grows a large variety of fruits and vegetables. Would you advise him to use direct marketing? Discuss fully.

11. Company A is a manufacturer of glass products. One of its most important lines consists of household products such as dishes, trays, etc. It has been dealing with retailers, but is dissatisfied with the volume of business obtained, and is contemplating changing to a policy of selling direct to consumers. Explain the factors which should be considered before it reaches a decision.

12. How can you account for the difference between Census of Business data on sales volume of vending machine operators and trade estimates of the sales volume of the vending machine merchandising industry?

13. Why do many regular retailers lease space to vending machine operators for the sale of certain items when they already have store facilities and personnel to sell such items by regular methods?

14. To what extent is the vending machine a producer of time and place utility?

15. In what principal ways do vending machines resemble leased departments?

16. What is the future outlook for mail order retailing? For house-to-house selling? For vending machine sales? Justify your answers.

IV

OUR WHOLESALING SYSTEM AND ITS PERFORMANCE

13

THE WHOLESALING STRUCTURE

This chapter deals with the general aspects of wholesaling in the United States, with emphasis on the nature of wholesaling, its relative importance, and the major elements of its structure. It is through this structure that retailers are largely supplied with goods, and most raw materials coming from the farm and large quantities of semi-manufactures, equipment, and supplies are moved to their destination—industrial or commercial use. The component parts of this wholesaling system are then discussed and analyzed in the five succeeding chapters Chapters 14 through 16 are devoted primarily to the wholesaling of manufactured consumer goods. The final two chapters in this part of the book are concerned with the wholesale marketing structure for manufactured industrial goods and for products of agriculture, respectively.

NATURE OF WHOLESALING[1]

Practically all important newspapers in the United States and certainly most of our trade publications regularly carry reviews of and comments on wholesale trade. The volume, status, and trend of such trade have long been regarded as significant indexes or barometers of general business conditions. Yet, as will be seen from the following discussion, no clear definition or conception of wholesaling was evolved until the results of the first Census of Wholesale Distribution were presented in final form in 1932. Even today, considerable confusion exists as to the meaning of wholesaling and

[1] For the serious student interested in a much more detailed analysis and discussion of wholesaling, including the operation and management of a wholesale business, attention is directed to T. N. Beckman and N. H. Engle, *Wholesaling—Principles and Practice* (rev. ed., rev. printing; New York: The Ronald Press Co., 1951).

the fundamental distinction between wholesaling and retailing. As a result, wholesaling transactions are often misconstrued as being synonymous with the sales made by establishments which are primarily wholesale in character or, more narrowly, with the business done by so-called merchant wholesalers or, in an even more restricted manner, with the sales of *regular* wholesalers made to retailers for the purpose of resale as distinct from their sales to industrial or business consumers. A considerable part of the discussion of this chapter is therefore devoted to a clarification of concepts regarding wholesaling.

Importance of Distinguishing Between Wholesaling and Retailing. It is necessary that the term *wholesaling* be properly and adequately defined and differentiated from *retailing* for the sake of truly understanding the essence of wholesaling and the manifold problems peculiar to it. The importance of making such a distinction arises out of both theoretical and practical considerations. It is essential to the quantitative measurement of each of these significant phases of our economy. No census enumeration can be made without such a distinction, nor can changes or trends in wholesaling and retailing be properly and respectively gauged without it unless the work is done on a sample basis. Certainly, no analytical study can be made of each of these parts of our marketing system without a clear-cut distinction between the two.

Practical considerations are sometimes even more vital. One of the most important of these relates to certain types of taxes. Many states and some cities impose a tax on *retail* sales. The question immediately arises: What is a retail sale? Under the enforcement of such tax legislation, taxes are unnecessarily paid on various kinds of nonretail transactions merely because of the confusion prevailing on this subject. The same is true of many state taxes on inventories or gross receipts. The amount or rate of such taxes may differ in a particular state, depending upon whether they are imposed upon wholesalers or retailers, higher rates generally being levied upon retail inventories or receipts. Furthermore, a number of states impose a chain store tax that applies only to retail establishments, hence an additional reason for distinguishing between wholesaling and retailing.

Another practical consideration concerns federal wage and hour administration. The Fair Labor Standards Act of 1938 set up minimum wages of 40 cents per hour and maximum hours of forty hours per week without overtime pay. This law was amended in 1949 and again in 1956, to raise the minimum hourly wage first to 75 cents and then to $1.00 and to broaden somewhat the scope of its coverage. The minimum wage and maximum hour provisions of the law do not apply to retail establishments unless over half of their business is in interstate commerce. To secure exemption from these provisions, it is necessary to prove that a business in question is a retail, not a wholesale, establishment.

Finally, for purposes of complying with the provisions of the Robinson-Patman Act, a seller may have to distinguish clearly between wholesalers and retailers and between wholesale and retail transactions of customers. For example, assume that a manufacturer decides to give wholesalers who buy from him a so-called functional discount of 20 per cent to be deducted from the price charged for the same goods when sold to retailers. Such a manufacturer is then confronted with two problems: first, of determining who is and who is not a wholesaler; and second, in the event of a *split-function* establishment (i.e., one that operates partly at wholesale and partly at retail), on how much of the total volume of purchases may such a discount be allowed. In such cases, the Federal Trade Commission has held that such a wholesaler is entitled to the 20 per cent functional discount referred to above only on that part of his purchases which he resells in a wholesale manner. That position obviously raises many complications and insurmountable practical difficulties, especially when similar or identical goods are bought from a variety of sources and it is impossible to determine whose products were sold at retail and how much.

Bases for Defining Wholesaling Transactions

Before any correct or realistic concept of wholesaling can be formulated, it is essential to understand the true nature of a wholesaling *transaction,* for it is the composite of such transactions that makes up the total of wholesaling or wholesale trade. In attempts to define such a transaction several bases have been used, the more pertinent of which are:

1. Price
2. The quantity of goods involved in the transaction
3. Method of operation of the selling concern
4. Status or motive of the purchaser

Price. It is generally assumed that there are more or less normal retail prices for quantities of goods purchased by ultimate consumers and that the sale of a given commodity at a price lower than the so-called normal retail price is probably in the nature of a wholesale transaction. While retail prices are *usually* higher than wholesale prices, this is not universally true and cannot be determinative in ascertaining the basic nature of a transaction. Loss leaders featured by price-cutting retailers are illustrative. In the food and drug fields, advertised bargains are sometimes sold to ultimate consumers at prices below those quoted by wholesalers to their regular retail customers. Similarly, clearance sales in department stores not infrequently feature some items at a price less than the actual wholesale cost to the store. Despite such lower prices, there is complete unanimity of agreement concerning the retail character of these transactions.

Quantity Involved in the Transaction. The term *wholesale,* or sale in *whole* rather than in small quantities, suggests a definition based upon the quantity of the merchandise involved in the transaction; hence a wholesaler is commonly thought of as one who buys and sells in large quantities, while a retail store is characterized by numerous small sales. Actual practice during the present century, however, has vitiated this basis for distinction as it is not uncommon for a druggist, for example, to buy from his wholesaler one-twelfth of a dozen of an item or some other very small quantity. No one would argue that this is a retail transaction. The federal courts, too, have declared time and again that "Whether a buyer is a wholesaler or not does not depend upon the quantity he buys. It is not the character of his buying but the character of his selling which marks him as a wholesaler."[2] Nevertheless, the quantity in a transaction, especially when viewed in the light of normal experience in a given line of trade, tends to indicate the nature of the transaction—whether wholesale or retail—but is by no means determinative.

Method of Operation of the Vendor. The method of doing business of the selling concern throws light on the nature of the business. There are certain principal attributes of a wholesale establishment, just as there are such attributes that characterize a retail store. A wholesale establishment usually employs outside salesmen, does not normally make sales over the counter to any substantial degree, and is not open to the general consuming public. In addition, its credit operations as judged both by procedure and services used are different from those employed by retailers. Wholesalers also belong to different local, sectional, and national trade associations or other groups. But it must be remembered that not all sales even by bona fide regular wholesalers are at wholesale, for to some extent many of them also sell to ultimate consumers for personal or household consumption. Similarly, it is not unusual to find a retail store selling merchandise to another retail store for purposes of resale. Such practices also occur occasionally when two retailers pool their requirements to place one large order from a manufacturer to take advantage of quantity discounts. The retailer actually placing the order then may settle the arrangement by selling part of the merchandise at cost to an associate. Consequently, this criterion of method of operation, while *generally* indicative of the nature of transactions, is, like the quantity involved in the transaction, far from being determinative.

Status or Motive of the Purchaser. The single clearest distinction between wholesaling and retailing transactions is that based upon the status or motive of the purchaser.

[2] C.C.A., 288 Fed. 774.

Theoretical Approach. On the basis of this criterion, all sales made to ultimate or individual consumers who buy the goods for their own use or for the use of their family constitute retail sales. It is equally clear that all goods, regardless of quantity involved, that are purchased by a customer for resale to his customers are sold at wholesale. Thus, when a filling station operator orders a single tire from the wholesaler for resale to a customer, the transaction is conducted in a wholesale manner. But a problem arises when goods are purchased, not for resale, but for further processing or as machinery and equipment to be used by a manufacturer, a retailer, a restaurant, or a builder of homes. The consensus is that all such transactions are made for business purposes and, consequently, are nonretail. So long as there are but two general classifications—wholesale and retail—they must at least by exclusion be classified as wholesale. *Wholesaling,* then, according to the clearest distinction that can be made, *includes all marketing transactions in which the purchaser is actuated solely by a profit or business motive in making the purchase, whether the goods are purchased for resale in the same form or for use in the business or industrial process.*

Practical Modification. The above approach, while theoretically sound, might under certain conditions, present insurmountable difficulties in a practical attempt to classify business transactions according to their wholesale or retail character. Such difficulties arise especially in connection with the purchase of goods for business use, when such goods are bought in an establishment operated essentially as a retail store (i.e., one that is open to the public and is so generally recognized) and are purchased in small quantities and perhaps also at the regular retail price. In instances of this kind, it would be exceedingly difficult to distinguish the business purchaser from the ordinary consumer and, indeed, in most instances there may be little practical reason for attempting to do so.

In the light of this problem, it is appropriate to modify the foregoing definition of wholesaling so that it is more workable under the stated conditions. *Wholesaling,* from such a viewpoint, *includes all transactions in which the purchaser is actuated solely by a profit or business motive in making the purchase, except for transactions that involve a small quantity of goods purchased in a retail store for business use, which transactions are considered as retail.*

This means that the following types of sales generally fall within the province of wholesaling:

1. Sales by manufacturers or their sales branches to wholesalers and other types of wholesale middlemen.
2. Sales to retailers of all kinds.
3. Sales to restaurants and hotels.
4. Sales to manufacturers, mines, oil well companies, fisheries, railroads, public utilities, and government departments.

5. Sales to barbers in the form of supplies and equipment. The same applies to all sales of equipment and supplies by all so-called supply houses, so long as such equipment and supplies are not purchased by ultimate consumers for their own personal use.
6. Sales of laboratory or office equipment and supplies to professional men such as doctors and dentists.
7. Sales of building materials to contractors, except when they act as agents of the home owners.
8. All operations and activities of middlemen who in some way aid in the transfer of title to goods when such goods are not sold to ultimate or individual consumers. In this group are naturally included brokers, resident buyers, purchasing agents, selling agents, manufacturers' agents, and the like.
9. All purchases of farm products for resale to others than individual consumers, irrespective of whether such purchases are made directly from middlemen.

The following types of transactions, while within the theoretical framework of wholesaling, are *illustrative* of sales that, for practical reasons under certain conditions, are considered as retail:

1. Purchase of one set (four or five) of tires by a retail grocer from a gasoline service station or a tire company's retail outlet, to be mounted on the grocer's delivery truck
2. Purchase of miscellaneous office supplies by a lawyer in the stationery department of a department store
3. Purchase of several items of upholstered furniture from a retail furniture store, by a manufacturing company, to furnish a reception room for visitors to the plant

Concepts of Wholesaling or Wholesale Trade

The various criteria which have been used, correctly or incorrectly, to define or indicate the nature of a wholesaling transaction have given rise to three main concepts concerning the totality of wholesaling which are identified with the following:

1. All wholesaling transactions, no matter by whom performed
2. The operations of wholesalers
3. The operations of all wholesale establishments

Broad Conception of Wholesaling. From a broad but entirely proper viewpoint, wholesaling embraces all wholesaling transactions, regardless of the character of the institution performing the wholesaling functions. It includes, therefore, all sales by agricultural producers, producers in the extractive industries, factories and processing establishments, except such sales as may be made by them to ultimate consumers; it includes,

obviously, the sales of all wholesalers and other establishments operating in a wholesale manner, except for the retail sales of split-function concerns; it includes, moreover, all sales by retailers to other retailers who buy for resale and sales by them to business users when such users are readily distinguished from ultimate consumers because the quantity purchased is more than an ultimate consumer would ordinarily buy.

The Narrow Conception. In ridiculous contrast to the broad concept is the narrow viewpoint, commonly held by laymen, that wholesaling is confined to the operations of regular wholesalers or of those who call themselves wholesalers, and even then it is limited to their sales to retailers for resale to ultimate consumers. The unrealistic nature of the narrow concept is demonstrated by the fact that very few wholesalers sell exclusively to retailers but number among their customers various business users and institutional buyers. The view is misleading, furthermore, because it fails to reflect the operations of thousands of specialized establishments that do business primarily in a wholesale manner, often just like regular wholesalers, but are not owned or operated by wholesalers.

The Middle View—Wholesaling in Terms of Establishments. While the narrow view of wholesaling is utterly preposterous, there are practical reasons for considering wholesaling in a somewhat less comprehensive view than the broad concept explained above. A middle and a very valuable conception is one based on the *institutional structure of business establishments primarily engaged in wholesale trade.* This view includes all transactions of such establishments, regardless of whether they are owned and operated by wholesalers, other wholesale middlemen, retailers, farmers, manufacturers, or other producers. It does not include, however, the wholesaling activities of producers or retailers who do not maintain separate establishments for such purpose. It is this concept that forms the basis for the discussion of our wholesaling *structure,* and it is this concept that underlies the various data collected and presented by the Censuses of Business and by the United States Department of Commerce as a whole.

For purposes of this book, however, when the term "wholesaling" or "wholesale trade" is used without direct reference to the structure, it refers to the broader and truer conception and embraces all transactions conducted on a wholesale basis, no matter who performs them. Just as there is a difference between *retail sales* (which may be made by farmers and manufacturers as well as by retailers) and *retail store sales* (which are made by retail establishments as reported by the Census), so there is a difference between *wholesale trade* that includes all wholesaling transactions no matter who performs them and *wholesale trade of wholesale establishments* that limits the conception to the transactions of establishments engaged mainly in wholesale trade.

Regardless of viewpoint, it is essential that the terms *wholesale establishment* and *wholesale transaction or sale* be carefully defined, for each figures in every concept of wholesaling or wholesale trade. Each of these two terms defies simple and categorical definition. This has already been shown in part in the preceding discussion of wholesale *transactions*. The meaning of the term *wholesale establishment* also has given rise to considerable controversy and calls for at least a brief discussion at this juncture.

What Is a Wholesale Establishment? A wholesale establishment may be defined as *a recognizable place of business that is primarily engaged in performing marketing functions, including the functions of exchange, on the wholesale level of distribution*. Such an establishment may be owned and operated by a bona fide wholesaler who takes title to the goods, by a wholesale middleman like a broker or commission man who does not take title to the goods in which he deals, by a manufacturer, by a farmer or group of farmers, or by a retailer. This is the general sense in which the term has been used by the Bureau of the Census and by other federal agencies, and this is the sense in which the courts have so far ruled that the term should be generally taken.

But the very definition just given implies possibilities for friction and difference of opinion on several scores. Among the most controversial questions are the following:

1. What is an establishment?
2. Is *ownership* of an establishment pertinent to its classification as a *wholesale* establishment?
3. How is primary emphasis upon marketing activities to be determined?
4. What proportion of the total business of an establishment must be done in a wholesale manner for it to be classified as a wholesale establishment?

With regard to the first of these questions, it may be stated that the term "establishment" refers to a *single* place of business. It is not synonymous with a company, a corporation, an organization, or an enterprise, unless such company, corporation, organization, or enterprise is coextensive with the single physical place of business. The place of business need not be an entire building but may be only part of a building, store, office, warehouse, or even part of a home from which business is regularly transacted, provided it is recognizable and can be identified as physically separated from other places of business. Under certain situations, a physically separated place of business may consist of more than one building. For example, lumber yards and petroleum bulk stations usually consist of fenced yards or grounds enclosing a number of structures and various types of physical facilities, but all are occupied and operated as a single business establishment. That all physical places of business operated by a single organization cannot be considered as consisting of a single establishment

has been made emphatically clear in an important federal court decision relating to chain store organizations. In a case where a defendant was seeking exemption from the provisions of the Fair Labor Standards Act, it was claimed that the company consisting of 2,300 retail stores, 11 warehouses, a main office, and several manufacturing plants was, in the aggregate, *a* retail establishment. The court denied most vigorously this assertion in stating that to regard the entire business of a chain organization of this kind as a single establishment "would do indescribable violence to the word 'establishment' in Section 13(a)(2)" of the Fair Labor Standards Act.[3]

The question as to whether *ownership* of a place of business is determinant in establishing its wholesale character has usually concerned the treatment to be given chain store and department store warehouses. Places of business owned by manufacturers and by farmers' marketing organizations, if operated in a wholesale manner, have been regularly considered as wholesale establishments. It has often been claimed, however, that warehouses operated by chain store organizations for the purpose of supplying the retail units of the organization are but part of the retail business of the enterprise. Even the Bureau of the Census has succumbed to this untenable view by failing to include the sales of such establishments in the Censuses of Wholesale Trade for 1935, 1939, 1948, and 1954, despite protestations from authorities and recommendations of a committee representing a scientific group, and contrary to the treatment accorded in the Censuses for 1929 and 1933. To say that chain store warehouses are retail establishments because they are part of a retail organization makes no more sense than to say that a wholesale establishment operated by a manufacturing company is a manufacturing establishment, or that a wholesale place of business operated by a group of farmers is but a part of farming. Whether a given place of business is a wholesale establishment is purely a matter of what it does, how it functions, and whether it operates basically in a wholesale manner. This view has been supported in the decisions of all the courts in which the question has been raised. The *functional* basis rather than the ownership basis of distinction has been consistently followed in interpretations pertaining to the coverage of the Fair Labor Standards Act. In the case of *A. H. Phillips, Inc., v. Walling,* for example, the court ruled as follows:

> We hold . . . that the warehouse and central office of petitioner's chain store system cannot properly be considered a retail establishment. . . .
>
> A warehouse and a central office such as petitioner maintains are vital factors in this integration of the retail and wholesale functions. They are necessary instruments for the successful performance of the wholesale aspects of a multifunction business of this type. . . .

[3] *Philip B. Fleming v. American Stores Company,* 133 F.2d 840 (1941).

The disappearance of the independent middleman, together with his separate operations and charges, does not mean, however, that his essential intermediary or wholesale function of moving goods from producer to retailer has been abolished. In this instance it has only been taken over by the retailer, acting through its own distinct wholesale units . . .[4]

In line with the reasoning advanced in this discussion, the authors have taken the position that wholesale warehouses operated by multi-unit retailing organizations must logically be considered as an integral part in any treatment of wholesaling. They have, accordingly, made appropriate adjustments in the wholesale census data presented in this book in order that the totals shown actually include the sales and billings of such warehouses.

The question as to whether an establishment is *primarily engaged in marketing functions* arises in various kinds of borderline cases in which it appears that a place of business might be considered either as a manufacturing or as a wholesaling establishment. Manufacturing is concerned with the creation of form utility and many wholesaling organizations are engaged in this, at least to some extent. Illustrative are wholesale grocers who roast and grind coffee or grade and package tea or spices, glass jobbers who cut window or plate glass to order and grind or polish edges, and industrial wholesalers who cut and thread pipe or fittings to the specifications of customers. When such manufacturing or processing activities are merely incidental to the performance of wholesaling functions, the establishment is regarded as wholesaling in character. On the other hand, there are many places of business that make wholesale sales but in which the primary function is that of manufacturing. Examples in this category are flour mills, food canning plants, automobile assembly factories, and paper mills. Such establishments usually exist basically for the purpose of giving useful form to the product, and thus they are enumerated as manufacturing establishments or factories and are outside the scope of the wholesaling structure, as conceived in the middle or establishment viewpoint.

Between these two rather clear-cut categories are a number of places of business of more doubtful status, and even the best informed persons find it difficult to effect a definite classification. An example is afforded by milk-bottling plants, which were included in the 1948 Census of Business as wholesaling establishments, because the preponderance of opinion at that time was that they were primarily engaged *in marketing* milk products. By the time of the 1954 Census, however, such plants were classified among the manufacturing industries, because it was considered that they were primarily engaged in form utility creation, including the separation of milk and cream, pasteurization, homogenization, and bottling of milk, and often

[4] *A. H. Phillips, Inc., v. L. Metcalfe Walling,* 65 Sup. Ct. 807 (1945).

the processing of related products such as butter, cottage cheese, and ice cream.

The question pertaining to the *proportion of wholesale business* required for classification as a wholesale establishment arises only in cases involving single places of business that operate both in a retail and in a wholesale manner. There are varying viewpoints on the matter. The most logical requirement is that followed by the Bureau of the Census in which the majority, or over 50 per cent, of the business, in dollar volume, is governing. Thus establishments are placed in retailing or in wholesaling categories according to their major activity. For purposes of the wage and hour provisions of the Fair Labor Standards Act, a broader rule was adopted for the determination of the character of an establishment. Section 13(a)(2) of the Act provides that "a 'retail or service establishment' shall mean an establishment 75 per centum of whose annual dollar volume of sales of goods and services (or of both) is not for resale and is recognized as retail sales and services in the particular industry."[5] Thus if more than 25 per cent of the sales are of a wholesale nature, the establishment may be recognized as wholesale and forced to comply with the provisions of the Act. Such a ruling undoubtedly has stemmed from the position repeatedly taken in U. S. Supreme Court decisions that for purposes of exemption a law should be construed narrowly and for purposes of coverage it should be interpreted broadly.

The situation is even further complicated by the Federal Trade Commission's practice of refraining from classifying an establishment as wholesale or retail, but insisting instead on treating each type of transaction on its own merits. Failure of the Commission to treat an establishment as a unit, while perhaps legally justified, has resulted in many complications in connection with enforcement of the Robinson-Patman Act. That position obviously raises many complications and insurmountable practical difficulties, especially when similar or identical goods are bought from a variety of sources and it is impossible, without a prohibitive system of detailed inventory and sales records, to determine whose products were sold at retail or wholesale, and how much in each case.

Volume of Wholesale Trade and Major Types of Institutions

The total volume of wholesale trade is generally an unknown quantity because data for all wholesaling transactions, as viewed from the truest and broadest concept discussed above, are not collected and published.[6]

[5] Public Law 393, 81st Congress, 1st Session.

[6] Estimates of the total volume of wholesale trade measured according to the broad concept are available for the years 1929–1950. These estimates reveal that the Census viewpoint of wholesale trade comprehends but about 45 per cent of the wholesale trade volume in the broad and truest sense. See Beckman and Engle, *op. cit.*, p. 85.

For practical reasons already indicated, the measurement of wholesale trade is restricted to the volume of business transacted by wholesale establishments as recognized by the Bureau of the Census, and it is the operations of such establishments that constitute the basis for all quantitative data presented in this discussion.

Volume of Wholesale Trade. The volume of trade transacted by wholesale establishments has fluctuated with changes in general business conditions. In Census of Business years prior to World War II, the actual volume in current prices declined from a high of $69 billions in the prosperous year 1929 to a low of $31 billions in the depth of the depression in 1933, and by 1939, a recovery year, volume increased to $58 billions. In the highly prosperous postwar year 1948, which was marked by a then unprecedented level of industrial production and business activity, wholesale trade approximated $190 billions and it increased to $247 billions for 1954.

A substantial part of these fluctuations is explained by price fluctuations growing out of changing economic conditions. In order to obtain a more revealing picture of the trend in the physical volume of goods distributed by the wholesaling system, it is necessary to adjust sales in current dollars by means of a price index and thus arrive at a *physical-volume equivalent* expressed in constant dollar values. The results of such a deflation are shown below:

Year	*Actual Volume at Current Prices*[a]	*Index of Wholesale Prices*[b] *(1954 = 100)*	*Actual Volume at 1954 Prices*[c]
1929	$ 68,950,108,000	56.1	$122,905,718,000
1933	31,441,153,000	38.8	81,033,899,000
1935	44,667,134,000	47.1	94,834,679,000
1939	57,797,363,000	45.3	127,587,998,000
1948	189,657,630,000[d]	94.7	200,271,942,000
1954	247,474,422,000	100.0	247,474,422,000

[a] Data in this column have been adjusted to include the sales of chain store warehouses. See Note to Table 17.

[b] Index of Wholesale Prices, All Commodities, published by the U. S. Bureau of Labor Statistics. Shifted, by the authors, from the base 1947-49 = 100 to 1954 = 100.

[c] Actual volume at current prices, divided by the index of wholesale prices and multiplied by 100.

[d] Retabulated by the Bureau of the Census to make 1948 data comparable with 1954.

A comparison of the physical volume equivalents reveals that sales volume data at current prices often convey a misleading impression. During the depression years of the 1930's, the *quantity* of goods distributed at wholesale did not decline as substantially as indicated by the actual volume in current dollars. While current dollar volume was less in 1939 than in 1929, physical volume was actually somewhat greater. Again, although the 1948 sales volume was some 2.9 times the 1929 level, much of this is explained by a higher level of wholesale prices. The physical volume of trade in 1948 was actually only 1.8 times that of 1929. Between 1948 and 1954,

the dollar volume at current prices increased by 30 per cent, but in terms of physical volume the increase was only 24 per cent.

Major Segments of the Wholesaling Structure. Based upon *types* of establishments, the wholesaling structure may be described as consisting of six major segments. Four of these are classes which are distinguished according to the ownership and method of operation of establishments, as follows:

1. Wholesalers: merchant establishments operated by concerns that are primarily engaged in buying, taking title to, usually storing and physically handling goods in large quantities, and reselling the goods, usually in smaller quantities, to retailers or to industrial or business users.
2. Manufacturers' sales branches: establishments that are maintained by manufacturers *apart from manufacturing plants* and which are operated by them primarily for the marketing of their own products at wholesale. Some of these maintain stocks of goods, whereas others are merely sales offices. Many of them also wholesale allied and supplementary lines purchased from other manufacturers.
3. Agents and brokers: functional middlemen who do not, for all or most of their business, take title to the goods in which they deal but who negotiate sales (or purchases) for their clients. Usually, they represent clients and are compensated in the form of commissions on sales or purchases.
4. Chain store warehouses: establishments that are operated by retail multi-unit organizations primarily for the purpose of assembling and distributing goods and performing other wholesale functions for the retail units of such organizations.

Two additional classes are distinguished, not on the basis of ownership, but because of the unusual character of their physical facilities or method of operation. These are:

5. Petroleum bulk stations: places of business engaged primarily in the storage and wholesale distribution of gasoline, oil, or other bulk petroleum products. These may be independent like wholesalers, or owned and operated by petroleum refining companies like manufacturers' sales branches, or by chains of gasoline service stations like chain store warehouses. They are segregated from wholesalers, manufacturers' sales branches, and chain store warehouses, because of the peculiar nature of their physical facilities, unique method of operation, and dealings basically in the same types of rather distinctive products, regardless of differences in ownership.
6. Assemblers: establishments engaged primarily in purchasing farm products or sea foods in growers' markets or producing regions. They usually purchase in relatively small quantities, concentrate large supplies, and thus assemble economical shipments for movement into major wholesale market centers. Such establishments may be owned and operated by mer-

chant wholesaling firms and hence are really part of the wholesale merchant classification; by manufacturers such as food canners or packers and to that extent they are really manufacturers' buying branches; by chain retailing companies and hence are not unlike chain store warehouses with emphasis on buying; or by farmers' marketing organizations.

As shown in Table 17, there has been a consistent trend for the total number of wholesale establishments to increase. Whereas there were about 170,000 such establishments in 1929, there were more than 253,000 in 1954. Such a rate of increase has not characterized each one of the individual segments of the structure, however, and some consideration of the number of establishments and sales volume importance of the segments is essential in order to ascertain to what degree stability is present in the composition of this structure over extended periods of time.

Establishments operated by wholesale merchants are the most numerous type. They have increased in number substantially and are responsible for about 40 per cent of the total volume of wholesale trade. Manufacturers' sales branches rank second in terms of sales volume, and have increased somewhat in importance in recent decades. While outranked numerically by three of the six major segments, they account for slightly more than one-fourth of the total trade. Agents and brokers are third in importance in volume of business, and while they have been increasing numerically, they have lost ground in relative volume importance. They transact about one-sixth of the total volume of wholesale business. These three segments, collectively, account for about 85 per cent of total wholesale trade.

A careful analysis of the major components of the structure, as revealed by the data in Table 17, would seem to justify the conclusion that fundamental changes in the general character of the wholesaling system are not to be expected over a relatively short period of time. While the total dollar amounts of trade volume and even of the physical volume of goods distributed change drastically with business conditions, the relative *proportions* allocated by the competitive economy among the various segments tend to remain fairly stable except where certain general upward or downward *trends* are discernible over an extended period of years.

Retail and Wholesale Sales Compared. Most laymen, if asked to speculate regarding the relationship between total volume of retail trade and total volume of wholesale trade, would likely reason that the volume of retail trade is ordinarily considerably larger. Two logical arguments might be advanced in support of such a conclusion. First, it may be reasoned that sales at retail usually involve a higher price than sales at wholesale and that, therefore, retail sales should naturally be higher by the amount of the retailer's margin. Second, it might be stated that many retailers do not purchase all of their goods from wholesale establishments and that such pur-

TABLE 17

NUMBER AND SALES VOLUME IMPORTANCE OF TYPES OF ESTABLISHMENTS WITHIN THE WHOLESALING STRUCTURE: UNITED STATES—SELECTED YEARS, 1929–1954

Institutional Segments of the Wholesaling Structure	Number of Establishments		Net Sales Per Cent of Total			
	1929	1954	1929	1939	1948	1954
Total[a]	169,654	253,618	100.0	100.0	100.0	100.0
I. Wholesalers	79,784	165,153	42.5	40.9	40.4	40.8
Regular or service wholesalers (domestic market)[b]	74,476	151,328	36.8	35.6	35.1	35.5
Export merchants	754	2,361	2.2	1.4	1.8	1.8
Import merchants	2,262	2,571	2.6	2.4	1.5	1.7
Limited-function wholesalers[c]	2,292	8,893	0.9	1.5	2.0	1.8
II. Manufacturers' sales branches	17,086	22,590	23.7	23.4	26.8	28.1
With stocks (warehouse facilities)	n.a.	14,759	n.a.	15.3	15.1	14.9
Without stocks (sales offices)	n.a.	7,831	n.a.	8.1	11.7	13.2
III. Merchandise agents, brokers (functional middlemen)	18,388	22,131	20.7	19.4	17.3	15.9
Selling agents	3,260	2,336	3.8	3.0	3.2	2.5
Manufacturers' agents	6,987	8,720	2.6	2.4	1.9	2.9
Brokers	3,689	4,359	5.8	5.9	4.9	4.4
Commission merchants	3,018	3,586	6.3	4.7	3.8	3.5
Other types, agents, agencies[d]	1,434	3,130	2.2	3.4	3.5	2.6
IV. Chain store warehouses[e]	559	1,300	2.8	4.4	4.8	5.0
V. Petroleum bulk plants, terminals	19,611	29,189	3.4	6.6	5.5	6.5
Refiner-marketer plants, terminals	n.a.	17,837	n.a.	n.a.	n.a.	4.4
Other petroleum bulk plants[f]	n.a.	10,482	n.a.	n.a.	n.a.	2.0
Wholesale L.P. gas facilities	n.a.	870	n.a.	n.a.	n.a.	0.1
VI. Assemblers (mainly farm products)	34,226	13,255	6.9	5.3	5.2	3.7

n.a. = not available.

[a] Totals for sales volume are as follows: 1929, $68,950,108,000; 1939, $57,797,363,000; 1948, $189,657,530,000; 1954, $247,474,422,000. The *Census of Business—Wholesale Trade, 1954* differs in several respects from earlier Censuses. In 1954, establishments without paid employees and milk-bottling plants were excluded, although covered previously. Data in this table for 1948 have been retabulated by the Bureau of the Census on a basis comparable with 1954 procedures, but this has not been possible for 1929 and 1939. Differences in Census procedures may account for some differences shown for various years, especially for limited-function wholesalers and some specific classes of agents and brokers, but do not have a significant effect upon basic trends revealed for the major segments.

[b] Includes all regular wholesalers of consumer goods, industrial distributors, converters, and terminal market wholesalers of agricultural raw materials.

[c] Includes cash-and-carry wholesalers, drop shippers, wagon distributors, and retailer-cooperative warehouses.

[d] Includes auction companies, export agents, import agents, purchasing agents, and resident buying offices operated on an agent basis.

[e] Chain store warehouses were included in the Census of Distribution for Wholesale Trade in 1929, but in the Census of Business for Retail Trade in 1939 and 1948 although tabulated separately from retail establishment data. Because such establishments operate in a wholesale manner, they are included in this and all other tabulations of total wholesale trade data in this text, except as otherwise indicated. Data for 1954 were not available at the time of publication, but have been estimated by the authors on the basis of trends in related data, as follows: establishments, 1,300 as compared with 1,080 in 1948; sales, $12.5 billions, compared with $9.1 billions in 1948.

[f] Includes plants operated by wholesalers or jobbers, retail chains of gasoline service stations, and cooperative marketing organizations.

Source: Compiled and computed from data from various publications of the U. S. Census of Business for the years indicated.

chases are not recorded in the volume of wholesale trade. Sales to retailers direct from factories not maintaining branch offices, or sales to retailers direct from agricultural producers not operating specialized wholesale assembly establishments are not considered in enumerations of wholesale trade as reported by the Bureau of the Census.

Such arguments, while logically tenable, are responsible for a widely prevalent misconception regarding relative wholesale trade volume. In spite of the validity of the reasons given, the total volume of sales conducted by wholesale establishments is usually from about 40 to 50 per cent greater than the total volume of retail store sales. The actual relationships for four widely separated years are shown as follows:

Year	*Retail Store Sales*	*Sales of Wholesale Establishments*	*Wholesale Sales as % of Retail Sales*
1929	$ 47,769,000,000	$ 68,950,108,000	144.3
1939	41,444,507,000	57,797,363,000	139.5
1948	128,849,252,000	189,657,530,000	147.2
1954	169,967,748,000	247,474,422,000	145.6

In order to provide an explanation for this relationship, it is necessary to consider the various classes of customers served by wholesale establishments and the relative importance of each.

Customers Served by Wholesale Establishments. An analysis of sales typically made by wholesale establishments by classes of customers (Table 18) reveals that sales by all wholesale establishments to retailers for purposes of resale account for only a little more than 38 per cent of the total sales volume of such establishments. Even so-called regular wholesalers sell less than half their volume to retailers. Some 62 per cent of the total wholesale trade is either never reflected in retail store sales statistics because the goods are not sold again in the same form, or involves duplication in sales before the goods reach the retail level of distribution.

The second most important class of customers consists of industrial or business users. Sales of installations, equipment, semi-manufactured goods, parts, supplies, or raw materials account for about 35 per cent of the total. This includes not only the sale of industrial goods to factories, but the purchase by retailers, wholesalers, and service establishments of goods that are used up or consumed in the business process.

Considerable duplication exists in the wholesale field because of the large amount of business transacted by one wholesale establishment with another wholesale establishment in selling goods for resale. Manufacturers' sales branches, for example, sell some goods to wholesalers and these same goods are sold again by the wholesalers to retailers. In fact, many wholesale merchants sell some of their output to other smaller wholesalers who then resell to retailers. Duplication of this kind accounts for some 21 per cent of the total wholesale trade volume.

A small proportion of the business transacted by wholesale establishments represents export business, either to export middlemen in this country or to buyers in foreign countries. Finally, a little more than 1 per cent of the total is accounted for by sales made directly to ultimate or household consumers.

TABLE 18

SALES OF WHOLESALE ESTABLISHMENTS, BY CLASSES OF CUSTOMERS—UNITED STATES: 1948

Type of Wholesale Establishment	Percentage of Sales Made to				
	Retailers for Resale	Industrial or Business Users	Other Wholesale Establishments for Resale	Household Consumers	For Export
Service and limited-function wholesalers	46.9	31.8	13.7	1.6	6.0
Manufacturers' sales branches (with stocks)	40.7	35.4	20.5	0.7	2.7
Manufacturers' sales branches (without stocks)	19.6	51.6	26.2	0.1	2.5
Petroleum bulk stations and terminals	64.1	35.9	*	*	*
Agents and brokers	16.1	41.8	36.5	0.4	5.2
Assemblers (mainly farm products)	9.4	32.6	51.8	5.3	0.9
Chain Store warehouses	100.0	—	**	—	—
Total, all types of establishments	38.4	35.3	21.1	1.1	4.1

* Sales to retailers include sales to all types of resellers; sales to industrial users include all sales to users or ultimate consumers.

** Insignificant proportion.

Source: *U. S. Census of Business—1948, Wholesale Trade, Sales by Class of Customer* (Washington, D. C.: Government Printing Office, 1951), Bulletin No. 2-W-4, Table 4-A

A careful study of the data in Table 18 should serve to dispel many false conceptions. They reveal clearly why the total volume of wholesale business is considerably larger than the total volume of retail store sales. The data for each type of wholesale operation show some important variations within the wholesale structure. For example, even businessmen who should know better often assume that *all* sales made through agents and brokers represent duplications in the wholesaling process. Few of them realize the extent to which such functional middlemen are used to serve retailers and industrial consumers, rather than operating completely between the form-utility producer and the wholesaler. It has also often been assumed that manufacturers' sales branches with stocks are employed primarily as a substitute for wholesalers, i.e., as a device whereby the manufacturer assumes the wholesaler's functions when circumventing him in the channel of distribution by selling direct to retailers. Actually the bulk of the sales made by such branches represents sales to industrial users or to other wholesale establishments purchasing for resale. Wholesalers are popularly viewed as agencies solely engaged in the distribution of consumer goods. While

retailers constitute the most important class of customers for this type of operation, it is quite significant that almost one-third of their business represents sales to industrial or business users. Information of this kind, when carefully studied and analyzed, gives one a better picture and a keener appreciation of the complexities of the wholesaling structure in the United States. It reveals also why there is so much misunderstanding regarding the subject and points to the need for careful attention if the various implications are to be properly comprehended.

Geographic Concentration of Wholesale Trade. Unlike retail trade, as discussed in Chapter 7, the wholesale trade structure tends to be heavily concentrated in major wholesale trading centers. As shown in Table 19, 52.5 per cent of the total *sales* of wholesale establishments is concentrated in the 14 largest metropolitan areas where, however, only 29.5 per cent of the total population resides.[7] The *number of wholesale establishments* is not so highly concentrated, as only 36.5 per cent are located in these same 14 areas. This indicates, as might be expected, that wholesale establishments in the largest trading centers tend to be of much larger than average sales volume size. One-third of the total establishments but only 15 per cent of the total wholesale sales volume is accounted for by establishments located in small cities and rural areas outside of the 172 metropolitan areas.

The degree of geographic concentration of sales volume varies considerably among different classes of wholesale establishments. For wholesalers, the pattern is very similar to that for all wholesale establishments. Manufacturers' sales branches and offices reflect the highest degree of concentration, since 63.9 per cent of their total volume is accounted for by establishments within the 14 largest areas and only 3 per cent by those located outside the 172 metropolitan areas. This is explained principally by the fact that such establishments sell to industrial users and to other wholesale establishments to a much greater extent than do wholesalers. The operations of agents and brokers are also concentrated in the largest wholesale centers to an extraordinary degree.

The business volume of petroleum bulk plants, which sell primarily to retail gasoline service stations, is dispersed very widely, correlating closely with the distribution of population. Assemblers are to be found chiefly in local growing regions for agricultural commodities. Consequently, their operations are so widely dispersed that 68.7 per cent of their total volume is accounted for by establishments located outside the 172 metropolitan areas.

[7] In general, a metropolitan area consists of a central city of more than 50,000 population plus the county in which the central city is located, and, sometimes, one or more additional counties provided that these are socially and economically integrated with the central county to a high degree. Loosely speaking, a metropolitan area is a city of large size and its suburban area.

TABLE 19

NUMBER AND SALES VOLUME OF WHOLESALE ESTABLISHMENTS (1954) AND POPULATION BY STANDARD METROPOLITAN AREAS AND REMAINDER OF COUNTRY—UNITED STATES

(Percentage distribution)

Area	Number of Establishments,[a] Total, All Classes	Sales Volume: Total, All Classes[a]	Sales Volume: Wholesalers	Sales Volume: Manufacturers' Sales Offices, Branches	Sales Volume: Merchandise Agents and Brokers	Sales Volume: Petroleum Bulk Plants, Terminals	Sales Volume: Assemblers	Population
14 largest metropolitan areas with population of more than 1,000,000 each[b]	36.5	52.5	50.1	63.9	58.1	27.4	11.5	29.5
158 metropolitan areas with population less than 1,000,000	30.5	32.2	34.3	33.1	28.9	30.9	19.9	27.0
Remainder of country	33.0	15.3	15.6	3.0	13.3	41.7	68.7	43.5
Total[c]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] Does not include chain store warehouses, except those classified as petroleum bulk plants.

[b] Includes Baltimore, Md.; Boston, Mass.; Buffalo, N. Y.; Chicago, Ill.; Cleveland, O.; Detroit, Mich.; Los Angeles, Calif.; Minneapolis-St. Paul, Minn.; New York-Northeastern New Jersey; Philadelphia, Penn.; Pittsburgh, Penn.; St. Louis, Mo.; San Francisco-Oakland, Calif.; and Washington, D. C. Sales volume of petroleum bulk plants and assemblers for Baltimore, Md., estimated.

[c] Totals are as follows: establishments, 252,318; total sales, $234,974,422,000; wholesalers, $101,100,941,000; manufacturers' sales offices, branches, $69,533,784,000; merchandise agents, brokers, $39,250,509,000; petroleum bulk plants, $16,038,372,000; assemblers, $9,050,816,000.

Source: 1954 Census of Business, Wholesale Trade.

Summary. In this chapter no attempt has been made to evaluate the wholesaling structure, either from its relation to the general economy or from the point of view of internal efficiency. It simply presents a portrayal of the wholesaling mechanism or structure in its barest outlines. Wholesale establishments may be classified according to numerous bases in addition to those suggested in the present treatment—according to ownership of the establishments, radius of operations, services rendered, or degree of integration with other types of activities. When such additional bases are employed, as is done in certain of the following chapters, many additional types or subtypes are revealed, each of which has evolved in response to a basic need for its services and each of which continues to exist only because in the long run it tends to perform essential functions. For a complete understanding, it is also necessary to examine various types of operation by lines of trade or kinds of business. When information is presented showing the accomplishments of wholesale establishments in the grocery field, the hardware trade, the drug business, or in other lines, the subject becomes more concrete and realistic. Much significant statistical material of this kind is also presented in the chapters that follow. Thus the student of marketing may not only understand the anatomy of the wholesaling mechanism but its functioning as well, see it in its historical perspective and clearly discern trends of major significance.

Questions and Problems

1. Define or explain the meaning of the following terms:
   - *a*) wholesale sale
   - *b*) wholesaling
   - *c*) wholesaler
   - *d*) wholesaling structure
   - *e*) manufacturing establishment
   - *f*) wholesaling establishment
   - *g*) merchant middleman
   - *h*) functional middleman
   - *i*) assembler
   - *j*) petroleum bulk station
   - *k*) manufacturers' sales branch
   - *l*) split-function establishment
2. Is the distinction between wholesaling and retailing merely of academic interest, or are there important practical reasons for making such a differentiation? Explain.
3. According to the clearest and most basic distinction that can be made, how are wholesale sales differentiated from retail sales? What bases for defining wholesaling transactions have been employed? Are all of these utterly meaningless? Explain.
4. Does the clearest and most basic distinction that can be made between wholesaling and retailing give rise to a broad, a narrow, or a middle concept of the totality of wholesaling? Explain.
5. What concept of wholesaling underlies the collection and publication of wholesaling data by the Bureau of the Census? Do the Census data accurately measure the sum total of all wholesaling activity in the United States? Explain.

6. Is there any good reason why officials of the Bureau of the Census and of the Department of Labor might have somewhat different definitions of a wholesale establishment? Explain.
7. Are chain store warehouses retailing or wholesaling institutions? Justify your answer.
8. Is the total of wholesale trade, as measured by the Census, smaller or larger than the total of retail trade? Explain the difference.
9. What are the six segments of our wholesaling structure, and what portion of the total wholesale business is accounted for by each? What significance might be attached to the relative stability of the wholesaling structure in so far as the major segments are concerned?
10. What is the most important class of customer that is served by each one of the major segments of the wholesaling structure? What class is second in importance in each case? Do the answers to such questions reveal any situations that might be contrary to popular opinion regarding various types of wholesaling institutions? Explain.
11. Choose a manufactured product which interests you. Consult the most recent Census of Business publications to determine the volume of wholesale trade which this product enjoys, and the portion of this trade conducted by each of the various types of wholesale establishments. Present this information graphically. Explain reasons for the relative importance of each type of wholesale establishment.
12. The activities of several business firms are listed below:

    a) An independent marketing concern, buying from wholesalers and from manufacturers; 60 per cent of the dollar volume of sales is to ultimate consumers and 40 per cent is to retailers who buy for resale.

    b) A manufacturing company that sells altogether from its single factory, largely to other manufacturing establishments.

    c) A manufacturer selling from the factory, designated as (C), *and* from three sales branches, which are designated as (C-1), (C-2), and (C-3), *and* from one retail store, designated as (C-4). About 3 per cent of total company volume is accounted for by the retail store which sells only to ultimate consumers. Sales from the factory and from the sales branches are of similar composition and involve about 75 per cent of sales to wholesalers who buy for resale and about 22 per cent of company sales to industrial users.

    d) An independent marketing firm, buying from manufacturers and selling altogether to retailers who buy for resale.

    e) An independent marketing firm, buying from manufacturers and selling almost altogether to industrial, business, or institutional users of the commodity it handles.

    Required: Classify each of these designated business firms or establishments under as many of the following headings as are appropriate: (1) wholesaler; (2) wholesale establishment; (3) engages in wholesaling, at least to some extent, according to the broad viewpoint.

14

WHOLESALERS

The discussion in this and the following two chapters is concerned *primarily* with the *wholesaling of manufactured consumer goods*. In this chapter, consideration is given to regular and special types of wholesalers, with emphasis upon their services to retailers as their principal customers on the one hand, and to manufacturers as their major sources of supply on the other. Conditions under which the wholesaler is circumvented and his functions are performed by manufacturers or retailers, respectively, are explored in the following chapter. In Chapter 16, the role played by major types of functional middlemen in wholesale distribution is considered in some detail. Following that, separate chapters are devoted to special circumstances which are encountered in the wholesaling of industrial goods and agricultural commodities.

Quantitative Position of the Wholesaler. As pointed out in Chapter 13, wholesalers are *merchant middlemen* that usually occupy a position in the channel of distribution between manufacturers or other sources of supply on the one hand, and retailers or industrial users of goods on the other.

The quantitative position of wholesalers is not well understood. Indeed, there are many who regard such institutions as antiquated marketing agencies and who hold the opinion that wholesalers have steadily declined in importance. Even among informed economists and businessmen, opinions are often expressed to the effect that "the wholesaler is doomed." Such opinions are doubtless due to a somewhat lesser role played by the wholesaler in a few industries. In dry goods, for example, wholesalers are not as numerous or significant as they were prior to the 1920's, primarily because of the growth of direct buying chain organizations in the general merchandise and apparel fields. Also, there has been an increase in direct-to-retailer selling by manufacturers in some lines of durable goods, notably automobiles and certain major household appliances. In spite of these

developments, wholesalers in most lines of trade have held their own or improved their position. Wholesalers, moreover, have played a very significant role in various newer industries which have experienced rapid growth in modern times. Illustrative are the automotive industries, electronics, chemicals, refrigeration, and air conditioning.

The significance of wholesalers is reflected by the number of business establishments they operate. For the year 1954 the Census of Business reported 165,153 *wholesaler* establishments, as compared with 129,117 for 1948, 101,627 for 1939, and 79,784 for 1929. Over the 25-year period 1929–1954, the number of establishments operated by wholesalers more than doubled.[1]

From the standpoint of sales volume, the record of wholesalers is also impressive. As previously indicated, they account for more than 40 per cent of the total sales volume of all wholesale establishments, and the volume of goods distributed by them has increased markedly, as shown in the following tabulation:[2]

	Sales Volume in 1954 Dollars (billions)		*Per Cent of*
	1939	*1954*	*Increase*
Wholesalers	$ 49.6	$101.1	103.8
All retail stores	88.5	170.0	92.1

Since the effects of price changes have been removed from the data in the foregoing presentation, it is apparent that the so-called physical volume of goods distributed by wholesalers has increased by 103.8 per cent over the 15-year period, 1939–1954. Furthermore, this rate of increase is greater than that experienced by retail stores by about 13 per cent. This, indeed, is convincing evidence that *the wholesaler has not only maintained his competitive position in modern times, but has actually improved it substantially.*

It has been estimated that about 45 per cent of all manufactured consumer goods is distributed through wholesalers. This amount does not represent the total volume of business transacted by wholesalers as many of them make sales to industrial consumers and some, such as the industrial distributor, specialize in sales of this type. Of all *manufactured* goods sold by regular wholesalers, however, more than 75 per cent consists of goods

[1] Actually, the rate of increase is greater than here indicated. In the 1954 and 1948 Census data, establishments without paid employees were excluded, whereas such establishments were included in the former Censuses. The number of establishments in 1954 would probably have been 12 to 15 per cent greater if compiled on a basis comparable with the earlier years.

[2] Data from the U. S. Census of Business for the respective years. Retail Store sales for 1939 were adjusted to 1954 on the basis of the U. S. Department of Commerce Index of Retail Prices, which stood at 99.0 in 1939 and 208.5 in 1954, based on a 1935–1939 average; 1939 wholesale sales data were adjusted to 1954 on basis of the U. S. Department of Labor Wholesale Price Index, which stood at 50.1 in 1939 and 110.3 in 1954, based on a 1947–1949 average.

destined for resale to ultimate consumers.[3] The bulk of this business is in goods of the convenience type, sold through independent retail merchants.

Regular or Full-Function Wholesalers

All the functions normally associated with the term "wholesaler" are performed by *regular* wholesalers, often called *full-function* or *service* wholesalers. They buy merchandise on their own account, operate from warehouses which serve as headquarters and for the maintenance of stock, sell usually through salesmen who call on the trade regularly, extend credit, make delivery, and assume risks incident to their business, including the risks of ownership of inventory and receivables. About 156,000 establishments are operated by regular wholesalers, which number includes subtypes designated as wholesale merchants, voluntary group wholesalers, converters, export merchants, importers, and industrial distributors. In total, they account for about 95 per cent of the sales volume transacted by all wholesalers.

In spite of the impressive quantitative position of regular wholesalers, they are not popularly appreciated as a productive type of institution. Many attacks have been levied against them, especially by those who have looked upon production in the narrow or form utility sense, ignoring the addition of economic value through the creation of time, place, and possession utilities. Since wholesalers have been able to survive changes in business in modern times and have been able to maintain and even improve their competitive position in spite of spirited rivalry with direct-selling manufacturers on the one hand and large, direct-buying retailers on the other, it must be inferred that they perform valuable economic services. The character of these services may be understood by approaching them, first, from the viewpoint of the wholesaler's customers and, second, from that of his sources of supply. From such an analysis, it will be apparent that distribution through wholesalers is not only desirable or absolutely essential under certain conditions, but that it also results in lower marketing costs to society than would be possible under any known alternative method of marketing.

Services to Customers. Services rendered by wholesalers to customers, especially in the retailer category, are of greatest significance when viewed in the light of the *typical* retail store. From the discussion in the preceding part of this book, it will be recalled that such a store is a relatively small, independent business, operated by an owner-manager, without benefit of numerous specialized employees, and handling a variety of merchandise

[3] T. N. Beckman and N. H. Engle, *Wholesaling—Principles and Practice* (rev. ed., rev. printing; New York: The Ronald Press Co., 1951), pp. 167–68.

manufactured by a number of firms located in different regions of the country often far removed from the store.

Anticipates Customer Requirements. One of the most important functions of the wholesaler is to anticipate the requirements of his customers. Most retailers do not find it feasible or convenient to keep track of sales by individual items of merchandise and are unable to determine their needs for merchandise except for short periods. Because the wholesaler operates on a large scale, it is possible for him to maintain careful stock control records and thus determine in advance the quantities of various items that will be needed to satisfy the requirements of his trade. Moreover, he constantly studies the offerings of manufacturers with one thought in mind, namely, whether the customers in his territory will be able to sell the offered merchandise in profitable quantities. This customer-mindedness involves both searching for new merchandise and dropping old items before they become obsolete.

Assembles the Goods. A vital function is that of assembling thousands of items from hundreds of manufacturers. Trained buyers judiciously select products from various sources, both at home and abroad, through a study of manufacturers' catalogs, interviews with suppliers' salesmen, observations of trade advertisements, and visits to principal market centers or trade shows.

The magnitude of this task is illustrated by the fact that there are over 50,000 plants manufacturing food and kindred products. In the absence of wholesalers to select from the offerings of these plants, every retail grocer would be faced with a horde of salesmen representing many of the manufacturers. He would be forced to buy directly in small quantities from many manufacturers rather than in economic quantities from one or a few wholesalers who make the offerings of hundreds of manufacturers easily and quickly available. In the absence of wholesalers, orders would have to be placed by mail, because few manufacturers could send their men to all the grocery or drug stores often enough to solicit business by personal calls The cost of the correspondence involved in placing such orders would be prohibitive. Visits to markets or to factory sales offices would be even more difficult, costly, and time-consuming for the small retailer.

A clear idea of the assembly job performed by the wholesaler is gained by considering the number of items carried in retail stores. An average retail grocer is said to handle from 1,200 to 3,000 items made by hundreds of manufacturers, and large supermarkets carry many more. Hardware merchants with 3,000 to 8,000 items and retail druggists whose stock may contain 12,000 items are keenly appreciative of the economic significance of the assembly function of the wholesaler. They know that they could not possibly undertake the task of assembling the variety of goods which

must be carried if consumers are to be satisfied. The procedure must be facilitated by using the wholesaler who brings together thousands of items which satisfy the requirements of not one, but all of his customers.

Buys in Economical Quantities. The wholesaler brings merchandise to his customers at lower costs than would otherwise be possible, partly because he buys from manufacturers in large quantities. In some trades, such as groceries, hardware, alcoholic beverages, and plumbing supplies, the quantity purchased is often in carload or truckload lots. This results in two kinds of economies. First, the manufacturer is able to sell to the wholesaler at a much lower price than he would have to obtain from retailers. Sales and handling costs are much lower on large orders, and such differentials are reflected in the pricing schedules offered to wholesale buyers. Second, transportation costs on large shipments are much less. Retailers buying in less-than-carload or less-than-truckload quantities would have to pay two or three times the carload or truckload rates obtained by wholesalers, and even more than this when buying in quantities of less than 100 pounds from a given manufacturer. These combined economies are often greater than the wholesaler's cost of doing business, with the consequence that goods are made available by wholesalers in local markets at prices lower than those which would otherwise prevail.

Maintains a Reservoir of Goods. The wholesaler creates time and place utility by storing goods near the point of ultimate demand. In the absence of wholesalers, retailers would be forced to carry much larger inventories in order that demand could be met at all times. Seasonal production of many articles would make it necessary to carry such products for months before they are sold. Since the wholesaler has a stock so close to most retailers that an order can be delivered within 72 hours after it is placed—and often within less than 24 hours—retailers carry a minimum stock and draw upon the reserves of the wholesaler at frequent intervals. Retailers order seasonal merchandise only in quantities which they feel will be sold with reasonable certainty and reorder if demand is greater than expected. Thus the retailer gains by increasing his rate of stock turn, by reducing the capital necessary to carry his inventory, by decreasing loss from obsolete merchandise, and by minimizing the effect of price changes.

The wholesaler's ability to store more economically than retailers could is attributed to several factors. One is that when a single reserve stock replaces several hundred stocks otherwise carried on the shelves of as many retailers, it can be much smaller in size and still meet the demands, for fluctuating demand from individual retailers is subjected to the law of averages when it is supplied from wholesale warehouses. Inventories of seasonally produced but regularly consumed products can be carried by wholesalers more conveniently and at less cost than by the average retailer, because

wholesalers are as a class better able to secure loans from bankers to finance their merchandise stocks. The physical warehousing is carried by wholesalers at less expense than would be incurred on stocks carried by retailers, for they are specialists and have effective storage space available. Many items must be stored under proper temperature and moisture control conditions and must be protected from vermin. Most retailers do not have facilities for rendering such special services and hence are glad to recognize storage as a proper function of the wholesaler.

Renders Prompt Delivery Service. In metropolitan areas orders are usually delivered to retail stores the day after they are placed with the wholesaler's salesmen. In rural sections deliveries are made once or twice a week under normal conditions. Three factors make it possible for wholesalers to deliver promptly: adequate stocks are maintained in the wholesaler's warehouse, the wholesaler is usually located in proximity to most of his customers, and trucks are commonly used for delivery. Many wholesalers own a fleet of delivery trucks for delivery to customers; in other cases, shipments are made by utilizing the fast service of commercial trucking lines. If a retailer's orders were placed with the factory, it would often be necessary to wait for the goods to be produced and then still longer for the slower transportation agencies to function. Not only does prompt delivery service aid in increasing stock turnover but it assists in keeping a clean, fresh, and salable inventory, in reducing loss from obsolescence, and in operating with a smaller investment.

Grants Credit. By extending trade credit, the wholesaler provides retailers with financial assistance. Without such service many merchants who possess real merchandising ability could not enter the retailing business, and many others would find it impossible to continue. Neither manufacturers nor regular financial institutions are as well equipped as the wholesaler with respect to providing this service.

In the case of the average independent retailer, credit-granting by the manufacturer would be uneconomical because of the distance separating him from his customers and the relative difficulty and cost of securing accurate credit information and in collecting overdue accounts. In the second place, it is doubtful whether the manufacturer would grant the retailer terms favorable enough to allow him to continue in business. A single retailer with his relatively small order is not important to a manufacturer of a limited number of items, but he is a vital element in the success of the wholesaler from whom he buys the products of hundreds of manufacturers. Hence he can be thoroughly and competently investigated and financed if the results would seem to justify such action.

Commercial banks and other financial institutions are a source of capital to many retail organizations, but they are unable to supply the total of

the outside financing needed by most stores. In fact, many independent retailers operate with such a small amount of equity capital that they cannot qualify for any type of bank financing. This is especially true of the smallest retailers, many of whom operate without the benefit of close accounting controls over their business and are unable to furnish accurate financial statements. The banker, moreover, lacks the constant contact with retailers which is available to the wholesaler through the continuing calls of his salesmen, who are able to detect changes in the status of a retailer's business and report such changes to the wholesaler's credit manager.

Because of their favorable position in this respect, regular wholesalers have found it desirable or necessary to extend credit to their customers, thus allowing the retailer to purchase merchandise and pay for it at a later date from funds derived from the sale of the same merchandise to the ultimate consumer. In this manner, wholesalers supply a large amount of the capital needed by independent retailers for the purpose of carrying an adequate inventory.

Provides Informational and Advisory Services. A very significant wholesaling service, one which has been greatly expanded during the 1950's, is that of providing retailers with information and assistance on retail store merchandising and operating problems. Progressive wholesalers realize that their prosperity depends, in the last analysis, upon the success of their customers. This has led to numerous attempts to strengthen working relations between wholesaler and retailer. As a consequence, wholesalers have provided various kinds of services which were at one time regarded as the sole function of the retailer.

An indication of the type of services provided by regular wholesalers is furnished by data from a survey of a large sample of retail drugstore owners.[4] More than 80 per cent of the retailers indicated that they sought the wholesaler's advice on retail store operating problems. The specific kinds of assistance most desired by retailers were ranked in order of importance, as follows: sales promotional advice; clerk training; information about other druggists' promotions; advice and assistance on display arrangements; advice on getting special displays; advice on store layout and arrangement; information on sources of items not stocked by the wholesaler; and managerial advice. In this study, more than 50 per cent of the retailers indicated that their wholesaler supplier was actually providing them with the kind of assistance that they wanted in each of these kinds of aid.

In this field the dynamics of technology and modern merchandising called forth new forms of assistance of an informational or promotional character. Changes in pharmaceutical lines have made it difficult or impossible for the retail druggist to keep abreast of a continuing flow of new

[4] *The Retailer Looks at His Service Wholesale Druggist* (New York: The National Wholesale Druggists' Association, 1953), pp. 10-13.

products. Consequently, many wholesalers have adopted special-service departments staffed by trained pharmacists employed for the express purpose of giving the retailer technical information. Such experts are equipped with files of special information and answer retailers' questions by telephone, as well as handle emergency orders for new or unusual prescription items not normally carried by the retailer.[5]

In many instances, the provision of additional services to the retailer has been accompanied by some modification of wholesalers' selling methods. In the grocery trade, for example, the use of "pre-printed" order forms has become common. The wholesaler's entire stock is listed on such forms which are published as booklets. This enables the retailer to make up a weekly order at a time of his own choosing, and it usually results in more carefully considered buying, since use of the order form serves as a careful check on the total stock. The wholesaler's sales representative is saved much time that would otherwise be spent in routine order-taking, and he is thus in a position to call on regular customers less frequently, spend more time in each store on his visits, and provide retailers with helpful merchandising assistance. In a 1956 survey of grocery wholesalers, 51 per cent reported the use of pre-printed order forms.[6]

Again, in this line of trade, especially when a close relationship has been established through a voluntary sponsorship arrangement or otherwise, the wholesaler is often prepared to provide store engineering and architectural service for the planning of new stores or the modernization of existing operations, financial aid for new stores, store equipment, stamp and other premium plans, and even aid in the selection of new sites. Such aids are by no means confined to wholesalers in the lines of trade used for specific references, but are to be found in varying degree in many other lines including hardware, plumbing and heating, dry goods, and variety type merchandise.

Services to Manufacturers. From the following discussion, it will be apparent that the wholesaler is in a better position to perform certain marketing functions much more efficiently and economically than is the manufacturer. This is based on the assumption, which is in line with established facts, that the average manufacturer is not a powerful business organization with unlimited capital and credit, far-flung branch houses, multitudes of trained salesmen, credit managers, advertising and other executives. While a few of the best-known manufacturing companies are of this character, the typical concern is a small unit in the business world. Often it is handi-

[5] Cf. Edwin H. Lewis, "Comeback of the Wholesaler," *Harvard Business Review*, November–December, 1955, p. 122.

[6] Robert W. Mueller, "The New Look of the Wholesale Grocery Industry," an address at the Annual Convention, National-American Wholesale Grocers' Association, Chicago, March 7, 1956.

capped by a lack of capital. The executives are frequently lacking in sales or marketing experience. Most of their time and energy is devoted to manufacturing problems, and they are glad to allow wholesalers to assume the functions of contacting and servicing retailers. Particularly is this true when only a single commodity or only a narrow line of products is manufactured. Under such circumstances the typical sale to the retailer is small and hence would be very costly if made direct. It is not surprising therefore that about 45 per cent of all manufactured consumer goods is distributed through wholesalers and that practically all manufacturing industries make some use of wholesalers.

Furnishes Advice as a Distribution Specialist. Because of intimate contacts with retailers, wholesalers can evaluate trends in demand and suggest desirable modifications in product lines. Most manufacturers are usually too far removed from ultimate consumers to do this effectively and count upon the wholesaler to estimate demand, provide help in preparing for it, and furnish warnings about changing consumer preferences that may be indicative of declining sales. Such details as the size of the unit, the type of package most in demand, and variations in quality are a part of his normal advice to the manufacturer. In the absence of the wholesaler, every manufacturer would be forced to conduct extensive market surveys to determine his potential market, its location, and characteristics.

Establishes Connections with the Whole Field of Retail Outlets. The wholesaler provides his suppliers with a definite clientele of relatively permanent customers who have been cultivated by his sales force, attracted by his service, and pleased with the quality of the merchandise he has recommended in the past. Hence when a manufacturer gets a wholesaler to sell his brand, whether it be because of price, quality, design, unique characteristics, national advertising, or any other factor which makes resales probable, retailers are more easily induced to stock the product than if the manufacturer were to present it to them through his own force of salesmen.

Earlier in this chapter it was shown that retailers would find it both difficult and time-consuming to make direct contact with all of the manufacturers whose goods they stock. It is equally difficult for most manufacturers to make direct contact with all retailers that sell the kind of product made by them. A manufacturer of food products, for example, might wish to eliminate the wholesaler and organize his own sales force to call on retailers. He would be confronted with the problem of contacting about 280,000 grocery stores, not to mention general stores or restaurants which are good customers for many kinds of such products. The problems of hiring, training, and maintaining a sales force adequate to make such contacts are so tremendous that they can be intelligently considered only by a very few of the largest manufacturers in this industry. Typical manufacturers

with national distribution find that they have problems enough in attempting to sell to full-line grocery wholesalers who, by way of comparison, are only about one per cent as numerous as grocery stores. Similarly, the manufacturer of a drug product would face the problem of contacting some 56,000 retail drug and proprietary stores if it were not for the wholesaler. By selling through a reasonable proportion of the some 390 full-line drug wholesalers, he is, however, able to reach all these retail outlets. Again, the manufacturer of an item sold through hardware stores would be forced to contact about 35,000 such retail establishments, plus many more thousands of building supply stores, lumber yards, and other retailers handling such merchandise, instead of only 606 general-line hardware wholesalers.

It is the wholesaler's function to establish connections with retailers even where there are unusual local or regional problems to be resolved. For example, in the state of Ohio, where distilled alcoholic beverages are distributed through state liquor stores, beer and wine are sold through regular licensed retail outlets. Over 11,000 retail stores sell wine for off-premises consumption, and about 20,000 restaurants, bars, taverns and others sell it by the drink or package.[7] For most such outlets, wine is only a small part of the total business, and the dealer has such limited capital and storage space that he is forced to buy in small quantities. By selling through some 20 to 30 wholesalers located in different trading centers throughout the state, wine producers are able to obtain distribution contacts with all the thousands of retail trade outlets.

Seeking to present his products to the retail trade, a manufacturer faces an almost insurmountable task unless he produces a very wide line of related products, or unless he finds it expedient to confine sales to retailers who are able to buy in unusually large quantities. Because most retail business is local and is done by small stores, a manufacturer who omits the typical merchant from his salesmen's routes eliminates a large portion of his market potential.

The wholesaler, on the other hand, is able to cultivate his entire territory of operation. Because of the large number of different items that he carries, he is able to consolidate products of different manufacturers into a single order, thus obtaining a sale of sufficient value to justify sales calls on the smallest merchants, even those located in tiny villages and at remote points not regularly served by our transportation system.

Reduces Costs of Physical Distribution. Because wholesalers customarily buy in economical quantities, a few large shipments from manufacturers to wholesalers are substituted for the more numerous small shipments to retailers that would be necessary in direct selling. This greatly reduces

[7] William R. Davidson, *The Wholesale Wine Trade in Ohio* (Columbus: The Ohio State University Bureau of Business Research, Monograph 74, 1955), p. 28.

transportation costs between the point of manufacture and local markets, enabling the manufacturer to present his merchandise to the consumer at a lower price than would otherwise be possible.

While the storage function of the wholesaler is of value to the retailer, it is just as valuable to the manufacturer. Because of specialized facilities and the fact that goods come to the wholesaler from a variety of manufacturers many of whom have seasonal peaks, though not all at the same time, the wholesaler can store more cheaply than can the manufacturer or retailer. As the space devoted to storing the products of one manufacturer is released by declining seasonal sales it can be utilized for another line just coming into seasonal demand. Partly for this reason, most manufacturers cannot use storage space as efficiently as does the wholesaler. Some full-line manufacturers can approach this efficiency and do so in warehouses located both at manufacturing plants and in the leading distributing centers. The great mass of manufacturers, however, must depend on the wholesaler for economical storage.

Additional savings in the cost of physical distribution are made by the wholesaler through simplification of order filling procedures, packing, checking, and shipping, in warehousing facilities especially designed for these important functions. By consolidating many items from different manufacturers for delivery to retail stores, the cost of handling and delivering an order is spread over all of the items on the order, and thus the cost per unit is minimized for each item.

Reduces Manufacturer's Capital Requirements. Because of quantity sales to wholesalers and comparatively low selling expense, the manufacturer can operate on less capital than would be required in direct selling to retailers. When the wholesaler stores for the manufacturer, he reduces the latter's investments in finished stock inventory which otherwise would be necessary. Wholesalers as a class pay bills promptly, another factor making for lower capital needs by the manufacturer. Furthermore, some manufacturers and processors actually receive direct financial assistance from wholesalers. In the food canning industry, for example, it is not uncommon for wholesalers to make advances to the canner in order that the latter may purchase raw materials and meet his payroll requirements.

Simplifies Accounting and Credit Problems. Because individual wholesalers carry the accounts of hundreds or thousands of retailers, the manufacturer need only account for sales made to wholesalers or other large buyers. Since orders from wholesalers are larger than from most retailers, the per order cost of accounting and shipping activities is lessened. Similarly, by carrying the accounts of retailers, the wholesaler reduces the loss from these accounts for, as already shown, he is in a better position than is the manufacturer to make investigations and grant credit to small retailers.

Wholesalers as a class generally enjoy a good credit rating, usually pay within the cash discount period, and sales to them do not involve a great amount of credit risk or bad debt loss.

Classification of Regular Wholesalers. In the foregoing discussion, regular wholesalers have been treated as a homogeneous group and this is characteristic of them in terms of basic services rendered to customers and suppliers. There is considerable disparity within the group, however, in terms of the extent of the line of goods handled by them and in terms of the size of the territory which they serve, each of which is an important competitive factor.

Line of Goods. On the basis of line of goods handled, wholesalers are classified as general-merchandise, general-line, and specialty wholesalers. Least numerous are the *general-merchandise* wholesalers who carry a variety of goods in several distinct and unrelated lines of business. Such wholesalers are of greatest importance in serving retailers in the more sparsely populated areas of the country. Because they serve general stores, many hardware outlets, automobile accessory dealers, electrical appliance shops, some furniture stores, drugstores, plumbing supply retailers, and farm implement dealers, the variety of merchandise is truly wide. The stores mentioned have one common characteristic; namely, they tend toward the so-called "hard lines," i.e., nontextiles and nonfood items. Stock is not easily perishable, neither is style a predominant quality. Some do carry such textiles as staple yard goods, notions, work clothing, and knit goods. This is particularly true in areas where the general store is important; in such cases the general-merchandise wholesaler attempts to carry all items in normal demand by general storekeepers. For this reason one may even sometimes find groceries in the stock of a general-merchandise wholesaler. The trend has been away from this type of organization and toward specialization in some one line of trade.

General-line wholesalers, sometimes called full-line wholesalers, carry a complete stock of some one type of merchandise, corresponding roughly to the stock carried in a single-line store. While less numerous than specialty wholesalers, general-line organizations are usually much larger and tend to be the dominant form of wholesaling volume-wise in the important jobbing lines such as drugs, hardware, and groceries. The principal competitive advantage of the general-line merchant is his ability to supply most of the requirements of his customers, the single-line stores. The general-line grocery wholesaler, for example, has canned goods, cereals, teas and coffees, spices, flour and cake mixes, sugar, soaps and cleansers, and some even carry perishable items such as frozen foods, meats, and fresh produce. General-line hardware wholesalers, similarly, stock most of the items to be found on the shelves of a regular retail hardware store.

Specialty wholesalers, often called short-line distributors, stock a narrow range of products. Examples are frozen food wholesalers in the grocery trade, pharmaceutical specialists in the drug trade, notions jobbers in the dry goods trade, beer wholesalers, "fine" paper merchants who limit their wholesaling activities to paper of printing quality, and many appliance wholesalers who confine their activities to the distribution of one or two manufacturers' lines for which they hold an exclusive franchise. Such wholesalers operate principally in well-developed markets where there are many retail outlets in the immediate vicinity. Because of the narrow range of products sold, order size tends to be smaller than for general-line competitors, and thus operating expenses are usually higher. Specialty wholesalers compensate for this disadvantage by more expert sales knowledge, a more complete assortment of goods within the range of products handled, and the ability to render prompt order-filling and delivery service.

Radius of Operation. From the standpoint of territory normally served, regular wholesalers are classified as local, sectional or regional, and national wholesalers. *Local wholesalers* operate within a single sizable city or within the trading area that can be served more advantageously by them than by wholesalers located in competing wholesale trade centers. They are the most numerous class and account for the bulk of the business done by regular wholesalers. Reasons for such dominance are not hard to find. For one thing, they seem to enjoy lower costs of operation than those incurred by the sectional or national concerns. In covering only sections which can be easily and comparatively inexpensively reached, both sales and delivery costs are materially less than those encountered by either of their competitive types. A large proportion of the sales force works in the house itself, in the city of the wholesaler, or within commuting distance of home, thus saving hotel and meal expenses. Organizations are simple in structure and do not involve elaborate accounting or supervisory systems. Owners are the managers as a rule, and the business benefits from the close contact resulting therefrom. Then, too, as is commonly true of smaller firms, at least a portion of the owners' compensation is frequently not charged as an expense against the business but appears instead as part of the business profits. Lower transportation costs give the local wholesaler a decided advantage. Not only can he save by securing carload rates on incoming shipments for longer distances, but he also saves on the shorter deliveries to his customers. Through his own or public service trucks he can give prompt delivery service. Emphasis by retailers on hand-to-mouth buying as a method of speeding stock turnover has definitely increased the importance of this advantage for the local wholesaler.

Sectional wholesalers operate over a large area that includes a number of wholesale trade centers and usually covers several states. Minneapolis,

Denver, St. Louis, Dallas, San Francisco, and Atlanta are representative locations of such firms. *National wholesalers,* as the name implies, cover all or a large portion of the United States. The competitive position of sectional and national wholesalers is somewhat similar, and varies in each class depending upon whether the wholesaler covers his territory from a single establishment or whether he operates a multi-unit organization.

Sectional and national wholesalers operating from a single place of business are much like local wholesalers in their home markets. When selling in distant territories, however, they are at a competitive disadvantage to local wholesalers who have a lower cost experience or who have a speed of service advantage. To compensate for this, many sectional and national wholesalers have integrated vertically, by assuming some functions normally performed by manufacturers.[8] Some have extensive lines of private branded merchandise which is produced according to the wholesaler's specifications and which is heavily promoted to the trade. When selling in distant markets, sales efforts are devoted chiefly to such private branded items for which direct price comparisons are not possible. Because sectional and national wholesalers are much larger organizations as a rule, they carry many more items than many local wholesalers and derive some patronage from an appeal based on their extensive variety and assortments.

In lines of trade where transportation costs are high or where speed or service is of paramount importance, sectional and national wholesalers are able to cover a large area only by the operation of branch houses or a chain of wholesale establishments. In this manner, they are able to move heavy or bulky merchandise into local markets at a transportation cost competitive with local wholesalers and are able to supply merchandise to retailers on a competitive schedule of delivery service. Illustrative of some of the leading national chain wholesalers are Consolidated Grocers Corporation, McKesson and Robbins in the drug trade, The Graybar Electric Co., and the American News Co.

Limited-Function Wholesalers

In addition to the various *classes* of regular wholesalers, there are several distinct *types* of limited-function wholesalers, so-called because they have placed emphasis upon reducing, eliminating, or modifying, certain well-established functions ordinarily performed by regular wholesalers. Their

[8] When a wholesaling firm engages in manufacturing activities to a significant degree, it is known as a *manufacturing wholesaler.* In the textile and paper trades, manufacturing wholesalers are known as *converters.* Textile converters are middlemen who purchase cloth in the grey and have it bleached, dyed, printed, mercerized, or sanforized before offering it for resale. Paper converters purchase some paper items in very large rolls or in large cartons of sheets and engage in rather simple forms of processing operations such as ruling, cutting, making envelopes, or assembling the paper into tablets or notebooks.

development over a period of several decades has not been accidental, but in line with the other marketing changes. Chief among these are: (1) the rapid growth of chain organizations during the 1920's and 1930's, (2) increased buying in urban centers and in types of stores which do not normally purchase from the wholesaler, (3) development of cooperative wholesaling, and (4) the growing tendency of some kinds of manufacturers to sell directly to retailers.

These changes have forced regular wholesalers to modify certain policies and have at the same time given an opportunity for the limited-function wholesaler to come into the picture. As will be shown below, such wholesalers as a class have certain advantages and a degree of mobility which has allowed them to adapt their services to changes in demand. The most important types are drop shippers, retailer-cooperative warehouses, cash-and-carry wholesalers, and wagon or truck distributors. Altogether, these several types accounted for 1.8 per cent of the sales of all wholesale establishments and 4.4 per cent of the sales of all wholesalers in 1954.

Drop Shippers. On the basis of sales volume the drop shipper or *"desk jobber"* is the most important limited-function wholesaler. He is so known because of the trade practice of referring to a shipment made directly from the factory to a retailer or industrial user as a "drop shipment." Drop shippers usually have an office but no warehouse, since they do not take physical possession of the goods. They are true wholesalers, however, because *they take title to the goods* and assume responsibility for the shipment after it leaves the factory. If a claim against the common carrier is necessary, it is filed by the drop shipper. If the shipment is rejected upon arrival, he must assume responsibility unless rejection was due to some fault of the supplier. He extends credit, collects the account, and incurs all the sales costs necessary to secure orders.

In 1954, there were 2,500 establishments operated by drop shippers. All but a small proportion of these are in two lines of trade: coal and coke, and lumber and construction materials. Carload shipments to retailers and industrial users are almost universal in these two industries, which makes warehousing unnecessary and gives the drop shipper an opportunity. Furthermore, the commodities are bulky and much can be saved by the elimination of handling and storing by the wholesaler. They are also of some importance in petroleum, farm products, and heavy machinery.

Since some costly functions are not performed by drop shippers, their operating expenses are relatively low, being about half those of service wholesalers in the same kinds of business. Entrance into this type of operation is fairly easy because a large fixed investment is not needed. Acquaintance with the trade and the confidence of a manufacturer that orders sent to him are bona-fide and that hence the drop shipper can collect and remit to him are important factors in their success.

The principal limit to the development of this business is that most of it must be in carload lots or in original packages. Only in a few industries is it possible for the wholesaler's customers to buy in such large quantities. Some manufacturers dislike the drop shipper and discourage his operations, for he tends to force certain functions back to the manufacturer, particularly that of storage and risk of obsolescence.

Retailer-Cooperative Warehouses. Ranking second in sales volume among the major types of limited-function wholesalers are the wholesale establishments operated by retailer-cooperatives. From the standpoint of establishments, they are least numerous, for there are only about 250 such places in the United States.

The origin, development, and operating characteristics of such businesses were discussed in some detail in Chapter 10. They are classed as wholesalers because they are usually set up as a corporate entity distinct from the retail interests that own them; and they buy, take title, and resell merchandise on their own account, sometimes even to nonmember retailers. Their operations as limited-function wholesalers are similar to those of cash-and-carry wholesalers discussed below, although some provide regular delivery service and offer merchandising counseling assistance like that of the regular voluntary group wholesaler.

Cash-and-Carry Wholesalers. Third in sales-volume importance are cash-and-carry wholesalers who operated 922 establishments in 1954. They are largely a product of the 1920's when many such businesses were established to give retailers a chance to meet chain store competition or to keep them from joining a cooperative which featured lower costs to prospective members. Since chain competition has been strongest in groceries, the cash-and-carry outlets are strongest in that line where they commonly operate as specialty distributors.

Some cash-and-carry wholesalers operate as single establishments; but most of them are in multi-units, either branches of a full-function wholesaler or units of a chain of such establishments. Assortments are limited to staple merchandise with a relatively quick turnover. Salesmen are not used nor is much advertising employed. Retailers come to the branch, pay cash, and carry the merchandise away in their own trucks. Original packages are not broken, nor is any particular time given to the customers. Orders are taken quickly and the goods are turned over with minimum delay.

Cash-and-carry wholesalers usually sell at lower prices than regular wholesalers, primarily because of cost savings which result from the curtailment of services to the trade. If a retailer is located close to a cash-and-carry establishment, so that he can readily assume the transportation function, and if he can pay cash for his purchases, he can effect some

savings by patronizing such a source. On the other hand, there are obvious disadvantages. Because of the streamlined stocks which are carried by cash-and-carry operators, the retailer will have to patronize certain other wholesalers to maintain his store inventory. Furthermore, he does not receive the benefit of important informational and advisory services of full-function wholesalers.

From a social viewpoint, the cash-and-carry plan of operation merely transfers certain well-accepted wholesaling functions from wholesaler to retailer. Usually, the retailer cannot perform these services as well as the wholesaler and this is the principal factor limiting the operation of cash-and-carry establishments.

Wagon Distributors, Rack Jobbers. The persistence of marketing terminology is well illustrated by the universal practice of referring to one type of limited-function wholesaler as a wagon distributor, whereas for many years a truck has been used rather than horse and wagon. Such wholesalers differ from the regular wholesaler principally in the combination of selling and delivery in the almost simultaneous performance of these functions, although orders may first be received by telephone and then distributed. An inventory of merchandise is carried on trucks which are operated by driver-salesmen. The retailer's requirements for merchandise are determined at the time of the sales call and orders are filled immediately from the stock carried on the truck. Wagon distributors are of importance principally in the grocery trade, and their stock is usually limited to specialty items or fast-moving perishables, which bear a good margin of gross profit but involve risk of deterioration and require constant attention. Common examples include potato chips, oleomargarine, cheese products, frozen foods, and specialty processed meat items. Normally the wagon distributor carries a very limited range of merchandise items and sells for cash.

A special type of wagon distributor has come into some degree of prominence in the years following World War II. This is the *rack jobber,* so designated because of the common practice of the distributor of installing his own display racks which are stocked with merchandise thereon displayed for sale. Rack jobbers are of importance chiefly in supplying nonfood items to grocery retailers, such as drugs, toilet articles, housewares, and notions. They developed with the expansion of nonfood merchandising in grocery stores, especially of the supermarket type, capitalizing upon the opportunity to supply grocers with merchandise items that they were not used to procuring from normal sources of supply. A "typical" rack jobber is described as operating 15 trucks driven by that number of driver-salesmen who, collectively, service about 300 retail stores three times a week.[9]

[9] "Rack Jobbers Prove Out As Merchandisers," *Printers Ink,* August 13, 1954, p. 23.

On a typical sales call, the driver-salesman inspects the retailer's stock of merchandise, determines whether any perishable items need be replaced, brings merchandise in from his truck in quantities believed salable by the retailer before the next call, often price-marks the merchandise, and actually places it on shelves or display cases. He usually writes a simplified form of invoice, collects cash for the merchandise that has been delivered, and proceeds to the next retail establishment on his route.

From the foregoing description, it might be assumed that wagon distribution or rack jobbing would entail low costs of doing business. One trip for both sales and delivery, one man to do both, low or no credit costs, quick turnover of a limited stock, and simplified record keeping suggest a favorable operating cost situation. The facts show the reverse to be the case. Average operating expenses are considerably higher than for regular wholesalers handling comparable lines of merchandise. A principal reason for the high costs of wagon distribution is the very narrow range of merchandise items handled, which gives rise to a low order-size and necessitates many calls to obtain a significant volume of business. Another factor is that the driver-salesman spends much time in the store selling, pricing, and arranging merchandise displays; and during all of that time expensive truck equipment remains idle. Such wholesalers have, nevertheless, achieved some degree of prominence within the field of their specialization because of their ability to concentrate selling effort on a few items, obtain distribution in a large number of retail outlets for manufacturers, and insure the adequacy, freshness, and arrangement of the stock displayed to the consumer in retail stores.

Split-Function Wholesalers. Some marketing organizations have integrated vertically and operate both on the wholesale and retail levels in the distribution channel. This is occasionally done by wholesalers, both of the regular and limited-function types. When a wholesaler sells at retail as well as at wholesale, he is usually known as a *split-function* wholesaler or as a *semi-jobber*. That retail sales are normally only incidental to the main business of conducting a wholesale firm is shown by the fact that they constitute less than two per cent of the sales made by all wholesalers. But in some lines of business, such as automotive supplies or farm products, retail sales by wholesalers are somewhat more significant than the average figure would suggest.

Some wholesalers operate as semi-jobbers because of the opportunity to make a substantial volume of sales at retail through the same facilities that are used for the wholesale operation. Some automotive parts wholesalers, for example, make sales at retail prices to any person who visits their establishments. In other cases, wholesalers actually operate retail stores. An example is provided by a long-established Ohio wholesale gro-

cery organization that built a number of supermarkets in order to obtain an assured market for a substantial amount of business within its trading area. Some retail sales by wholesalers result from the initiative of persons who believe that if they buy from wholesalers, they can secure goods at lower prices. Friends of the wholesaler and of his employees often importune him to sell to them at the same price which he charges retailers. Many wholesalers resist; others succumb to the pressure and make such sales at prices which range from just over the price paid by retailers to just under the amount charged by retailers. Many wholesalers follow a rigid policy of never making such sales, because they do not believe that it is either fair or wise to compete with their own customers. Other wholesalers, frequently those not particularly successful, are willing to sell to anyone who can pay for the merchandise and thus, in effect, operate as "discount house" retailers. This practice may be criticized on the grounds that it tends to undermine the existing distributive structure which evolution and competition should have caused to be the most efficient mechanism for performing the marketing task.

A second example of vertical integration is the retailer who assumes some wholesale functions and thus engages in semi-jobbing. He is primarily a retailer; the semi-jobber, on the other hand, is primarily a wholesaler. Often the start is made at the suggestion of a manufacturer's salesman that the retailer solicit orders from some friendly competitors and thus purchase from the manufacturer at better wholesale prices based upon the larger quantity. Other retailers merely print a letterhead and call themselves wholesalers because certain manufacturers will quote them wholesaler prices even though they do not perform a single wholesaling function. The more common practice is, however, that of pooling orders under the leadership of one retailer, or of a large and adequately financed retailer ordering more than he needs and selling the surplus to nearby retailers. Prices received are usually somewhat under those charged by the regular wholesaler, since fewer services are provided on such transactions.

Semi-jobbing on the part of retailers is frowned upon by both manufacturers and the full service wholesalers. Students of marketing usually unite in the belief that efficiency in distribution is enhanced by minimizing overlapping functions. Certainly, loss follows the effort of any marketing organization that tries to perform functions for which it is not well suited.

The practice of operating split-function establishments is somewhat limited by the Robinson-Patman Act. In certain interpretations of this law, it has been held that a semi-jobber is entitled to receive the wholesaler's functional discount when one is offered by a manufacturer only on that part of his purchases which is to be resold at wholesale and that he must pay the price ordinarily paid by other retailers on the portion to be resold

by him at retail.[10] Because of the practical difficulties of such a classification of a semi-jobber's purchases of any one commodity, there has been a tendency to curtail the dual functioning of an enterprise or to form separate corporations for the purpose.

Conclusion. In this chapter it has been demonstrated that wholesalers occupy a very strategic position in the distribution of goods. Furthermore, statistics have been presented to reveal that wholesalers have not only maintained their competitive position in modern times but have actually improved it during the 1940's and 1950's. The dynamics of wholesaling has been illustrated by the variety of forms of operation used by wholesalers in particular marketing situations. Finally, throughout this chapter, the wholesaler has been depicted as a productive type of business institution, adding economic values through the creation of time, place, and possession utilities and, at the same time, benefiting the public through lower costs of distribution than would be possible under similar circumstances in his absence from the channel of distribution.

In conclusion, it should be recalled that the services of wholesalers have been examined under particular conditions set forth in early parts of the chapter. That the advantages of buying or selling through wholesalers do not obtain for all types of commodities or in all kinds of market conditions will be apparent in the following chapter which deals with the assumption of wholesaling functions by retailers and by manufacturers, respectively.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) wholesaler
   b) wholesale merchant
   c) regular wholesaler
   d) limited-function wholesaler
   e) manufacturing wholesaler
   f) converter
   g) split-function wholesaler
   h) semi-jobber
   i) general-merchandise wholesaler
   j) general-line wholesaler
   k) specialty wholesaler
   l) drop shipper
   m) desk jobber
   n) wagon distributor
   o) rack jobber

2. In a recent address, a critic of our marketing system observed that "wholesalers were very necessary in the last century, but they must be regarded as antiquated institutions in a modern age characterized by instantaneous communication and rapid transportation, and dominated on the one hand by gigantic manufacturing companies with nationally advertised products and on the other hand by urban shopping centers populated with stores operated by large chain, department store, and mail order companies." Do you agree with such a statement? Explain in some detail.

[10] For a discussion of the nature of functional discounts and their legal status, see Chapter 33.

3. Would the regular or service wholesaler be *more* or *less* essential under each of the following conditions, assuming other things remained the same? Explain.
   a) If manufacturing were less specialized
   b) If all our people lived in large urban communities
   c) If there were no restrictions whatever on prices charged to customers
   d) If our banking system were to furnish all the capital needed by business for short-term purposes
   e) If enterprise were less free and more restricted
4. Examine the classified portion of your city's telephone directory devoted to wholesalers and note the lines of business in which they operate. Are all of these lines of trade old? If not, how do you explain the use of wholesalers in the new fields where the most modern marketing institutions should be in order?
5. An old, retired, and successful retail merchant gave this advice to a young friend of his who was planning to open a grocery store. "Pick out a few good and reliable wholesalers at the start and then stick to them. Don't buy from every salesman who stops at your store. Don't buy from them just because they can give you a special deal on a few items. It is poor business in the long run to do so." What possible reasons are there for this sort of advice? Would you agree with such advice under modern competitive conditions, or is this "old-fashioned" advice that has been outmoded?
6. You are a retailer with limited working capital. It is, therefore, necessary for you to finance your purchases by borrowing from the bank or by buying on credit from your wholesalers or from manufacturers. Which of these sources is likely to be most liberal in providing you with your credit needs? Explain.
7. With all the advantages which accrue to both retailers and manufacturers through the use of wholesalers, how do you account for the limited use of wholesalers in the distribution of certain commodities such as furniture, refrigerators, and ladies' dresses?
8. Would it improve the efficiency and lower the costs of our marketing system if we were to eliminate wholesalers, cut out manufacturers' salesmen, and sell all goods on a factory-to-retailer basis through catalogs? Explain.
9. How can you explain the fact that private brands have been used more extensively by sectional wholesalers than by local wholesalers?
10. Smith is operating a grocery store in a city of 400,000 population. He is located near the central part of the city and within several blocks of a regular grocery wholesaler, three specialty wholesalers in the food lines, and a cash-and-carry wholesaler. As competition is very keen, it is necessary for him to buy at the lowest possible prices. Which of these establishments should he patronize? Would his choice be different if he were located in a small town 50 miles from this city? Explain.
11. The Nelson Products Company originally was a wholesaler of fishing equipment and hunting supplies. Later it added tennis, golf, basketball, football, and baseball equipment in order to expand its business. Several years later, in a war period, it could no longer obtain many items of regular merchandise so toys, some household items, small electrical appliances, and garden supplies were added to maintain sales volume. These were dropped as soon

as regular merchandise was again available, but the company then began to manufacture certain items such as artificial baits. When the company started business it restricted its sales to local merchants. As it added to its offerings it also expanded its operations and was soon selling to dealers in the three surrounding states. Classify this establishment on all possible bases at each stage of its development.

12. Over a period of several decades, have limited-function wholesalers as a group been gaining or declining in relative importance? How can you explain the answers?

13. What functions of the regular wholesaler are eliminated by drop shippers; by cash-and-carry wholesalers; by wagon distributors? Does the elimination of these services result in lower costs of operation for each of these institutions than for regular wholesalers? If so, does this mean that the total costs of distribution are lowered correspondingly? Explain.

14. What competitive advantages are enjoyed by local wholesalers? If these advantages actually exist, how is it possible for sectional and national wholesalers to operate? Explain.

15

WHOLESALING BY RETAILERS AND BY MANUFACTURERS

Not all manufactured goods are supplied to retailers and others through wholesalers. Only about 45 per cent of all consumer goods manufactured in the United States is sold through this channel.[1] The most important channel used in the distribution of the remaining 55 per cent is from factory to retailer. A considerable proportion is also sold through manufacturers' sales branches to retail stores. Small proportions are sold through manufacturer-owned retail stores or are marketed directly from factory to home consumer.

Examples of Minimal Utilization of Wholesalers. In some lines of trade the wholesaler has declined in significance, and in others he was never an important factor in the distribution channel. Four fields, including groceries, drugs, hardware, and dry goods, have always been considered jobbing lines, i.e., lines of trade in which the wholesaler predominates. In certain other lines of business, as in automobile accessories other than tires, tobacco products, plumbing supplies, and electrical goods, the wholesaler has been used as the principal method of moving goods from manufacturer to retailer. In practically all lines of trade the wholesaler has been utilized at least to some degree. There are some industries, however, in which sales are most commonly made by manufacturers to retailers without the use of independent wholesale merchant middlemen.

The automobile industry provides an excellent example of an industry in which the wholesaler was at one time dominant but is now of negligible

[1] T. N. Beckman and N. H. Engle, *Wholesaling—Principles and Practice* (rev. ed., rev. printing; New York: The Ronald Press Co., 1951), p. 168.

significance. In the early days of this industry (prior to World War I), the industry was characterized by uncertain sales and a low volume of production, manufacturers and retailers with weak financial resources, and a highly concentrated manufacturing center (the Detroit area) serving a broad national market. Under such conditions manufacturers sold automobiles predominantly through wholesale distributors to retailers. The distributor organization permitted manufacturers to concentrate on production problems when the industry was in the developmental stages; it filled an important financial gap because manufacturers lacked the capital resources required for wholesaling; it performed the storage function necessitated by the seasonal sale of cars; it provided a decentralized system of warehouse depots required to render prompt delivery service to dealers in distant markets; and it provided intensive selling in local markets of the kind needed to build a retail dealer organization.[2]

During the 1920's and 1930's, the automobile industry experienced very rapid growth and its characteristics were modified in a manner that minimized the need for wholesalers. Manufacturing companies grew in size and were able to command needed capital in the national money markets. Production was decentralized through the construction of assembly plants in various parts of the country. Sales finance companies developed to provide special services in financing dealer inventories and sales of automobiles to consumers.[3] Dealers grew in size and stature and concentrated their efforts on one manufacturer's line of cars; as a consequence, they had large annual purchasing requirements from a single source of supply. As a result of all these environmental changes, adaptive behavior in the industry took the form of largely supplanting the independent wholesale distributor with direct sales from manufacturer to retailer.

The ready-to-wear apparel industries are examples of situations in which wholesalers have never been of great importance. The men's clothing industry expanded rapidly following the War between the States, as a result of mass production developments stemming from the manufacture of military uniforms during the war period. From the very outset, most manufacturers sent out traveling salesmen to call upon retail clothiers. The production of men's suits is an extremely complicated undertaking requiring a long manufacturing cycle. Orders are usually obtained from retailers in advance of production. The unit value is high, dealers are not relatively numerous; and they must make a substantial investment in inventory. These factors, characteristic of the industry in its early stages as well as in modern times, gave rise to the need for direct contact between manufacturer and retailer. In 1950, it was estimated that manufacturers who sell direct to

[2] Charles N. Davisson in Richard M. Clewett (ed.), *Marketing Channels for Manufactured Products* (Homewood, Illinois: Richard D. Irwin, Inc., 1954), pp. 94–95.

[3] Sales finance companies are treated in detail in Chapters 25 and 26.

clothing stores and department stores accounted for 70 per cent of the total industry volume of men's suits, and that manufacturers who distribute through their own retail stores accounted for about 20 per cent (e.g., Bond Clothing Co., and Richman Bros. Co.).[4]

The women's ready-to-wear apparel industry is characterized by a concentration of consumer shopping in large shopping centers; by a speedy production cycle, enabling most manufacturers to give prompt delivery from the factory on reorders of popular styles; by a limited number of concentrated manufacturing centers which are also wholesale buying markets for retailers; by marked seasonal shifts in the character of demand; and by rapid fashion obsolescence. The major retail outlets operate on a fairly large scale, consisting chiefly of department stores, departmentized specialty stores, and chains of women's ready-to-wear establishments. More than 85 per cent of the output of women's dresses, coats, and suits is sold direct from manufacturer to retailer.[5] In spite of the dominance of direct selling in these industries, wholesalers are used to some extent, especially in supplying smaller retailers in communities most distant from the major market centers in which manufacturers are concentrated. Wholesalers are of considerable importance in merchandising more staple items of apparel and accessory items, including men's work clothing, underwear, hosiery, and millinery.

Wholesalers play a very limited role in the distribution of some perishable products and other commodities which are manufactured or processed chiefly by local establishments. In the field of meat products, the activities of wholesalers are limited chiefly to specialists in specific kinds of meat items who are located in major cities, and who often cater primarily to special segments of the trade such as restaurants and hotels. Most meat products sold in ordinary grocery stores and meat markets come directly from meat packing plants or from wholesale branches operated by the major meat packing companies.

Bakery products, dairy products, and carbonated bottled beverages are examples of products which are manufactured in all cities of significant size and which are sold almost altogether direct to retail stores. Such manufacturers use a method of sale like that of the wagon-distributor type of wholesaler discussed in the preceding chapter.

While the foregoing examples are selective and limited in number, they serve to illustrate the manner in which marketing channels tend to be adapted to particular conditions, and they set the stage for the more general discussion in the following sections.

[4] L. N. Rieman, in Richard M. Clewett (ed.), *op. cit.*, pp. 255, 260.

[5] John W. Wingate and Raymond B. Voorhees, in Richard M. Clewett (ed.), *op. cit.*, pp. 345–50.

Reasons for Bypassing the Wholesaler

Usually, manufacturers rather than retailers take the initiative in establishing direct producer-retailer contact. In this effort to circumvent the wholesaler the manufacturers may be prompted by one or more of the following principal motives: (1) necessity of moving perishable or style goods through trade channels with the greatest possible speed; (2) desire to secure closer control over the product; (3) desire for economy; (4) desire to maintain or improve the competitive position; and (5) dissatisfaction with the wholesaler's services. Other motives of lesser importance may consist of: (1) a desire to sell a small portion of the output direct for purposes of experimentation in an effort to improve regular channels; and (2) need for supplementing inadequate wholesaling facilities existing in some of the manufacturer's markets with his own wholesaling outlets.

Perishable Nature of Goods. Perishability is a characteristic that tends to make the direct sale of some goods desirable. Some commodities are subject to rapid physical deterioration, as is the case with baked goods, dairy products, and meat. It is important that few handlings be involved and as little time as possible elapse in the movement of such items from processor to retailer. Direct contact in the sale of such items enables a manufacturer to follow up his product and prevent the resale of stale and unsuitable merchandise bearing his label, in this way safeguarding the good will of the consuming public. It also enables him to oversee the care and treatment accorded his product prior to its sale to the ultimate consumer.

A second characteristic of perishables making merchandise well fitted for direct sale from manufacturer to retailer is rapid fashion change. Loss occurs when ladies' ready-to-wear, shoes, or millinery are delayed in passing from manufacturers to retailers. Hence wholesalers have found small opportunity to handle such merchandise, largely reserving for themselves articles for which fashion changes are less frequent, less drastic, or more predictable.

Some wholesalers have adapted their technique in handling style goods to the needs of current merchandising practice by stocking large assortments of such goods as gloves, hosiery, and millinery. This appeals to retailers who wish to reduce the loss from style obsolescence and at the same time be sure of a replacement stock. About one-third of the output of hosiery mills is sold through wholesalers largely for this reason.

Desire for Closer Control Over Product. There is a strong desire on the part of manufacturers of certain goods to exercise close control over their products until they reach the ultimate consumer. This is true, for example, of some manufacturers of furnaces and of sewing machines where success in the long run is dependent to a substantial degree upon the quality of the servicing work. In order to insure proper installation and service, manu-

facturers have in many instances taken over wholesaling functions. In the case of some specialty goods, it may be advantageous for the manufacturer to control also the entire sales program. Some manufacturers have attempted to accomplish this, at least in part, by integrating the wholesaling and the manufacturing tasks and processes.

Economy as a Motive. A desire to reduce the cost of selling through wholesalers by undertaking the performance of his functions leads many manufacturers to direct selling, either with or without branch houses. Many believe that greater volume can be secured, thus reducing manufacturing overhead, and perhaps also the cost of selling may be less than the margin allowed to the wholesaler. Many, however, have learned to their sorrow that elimination of the wholesaler does not eliminate his functions. They have also learned that frequently he can perform these functions more cheaply than can the manufacturer. Reasons for this have been explained in Chapter 14. Many manufacturers have come to the same conclusion; they admit that economy is not always the basic motive for going around the wholesaler. Economy may be effected only when the manufacturer performs the wholesaling functions more efficiently than or at least as efficiently as does the wholesaler.

Dissatisfaction with the Wholesaler's Services. One of the most important reasons for circumventing the wholesaler, even in lines in which he is generally utilized, is dissatisfaction with his services. Where this feeling exists, it is based on one or more of three grounds. Wholesalers have been charged with: (1) lack of intensive cultivation; (2) indifference or even hostility to a manufacturer's advertising or sales program promotion; and (3) pushing private brands at the expense of competing brands of manufacturers.

While such allegations are sometimes founded in fact, they often result from a misunderstanding of the nature of a wholesaler's operation. A regular, general-line wholesaler ordinarily carries a number of brands in each product classification and handles a wide range of product classes. He cannot justifiably single out one manufacturer's product line for intensive selling attention unless he has some special incentive for so doing. Manufacturers who desire to obtain extra selling or merchandising effort from wholesalers usually find it necessary to provide compensation for this by means of additional discounts or promotional allowances, or by giving a wholesaler exclusive rights for distribution within his area of operation.

Desire of Retailers to Buy Direct. Pressure for direct manufacturer-retailer contact often comes from retailers. In hopes of securing goods at lower prices and gaining certain other buying advantages, department stores, chain stores, and mail order houses generally desire to purchase their mer-

chandise requirements directly from manufacturers. Patronage of wholesalers is then confined largely to fill-in orders. Many smaller stores have attempted direct buying, frequently through participation in one or more buying groups. Advertising allowances and special discounts have often been secured from the manufacturer by large direct-buying retailers, in addition to the lower prices.

In some instances, pressure by retailers for direct-buying arrangements has been accompanied by threats of discontinuing the manufacturer's brand unless such a request is granted. If the retailers in question account for any significant proportion of the manufacturer's sales volume, he may be forced to choose between losing their business or acceding to their wishes. Thus, sometimes a manufacturer who actually prefers to distribute entirely through wholesalers may choose to circumvent the wholesaler.

Conditions Favoring Direct Manufacturer-Retailer Relationships

Regardless of the strength of motives that a manufacturer may have for circumventing the wholesaler in the channel of distribution, this may be impossible or highly impractical. Unless motivation is accompanied by the presence of certain conditions favoring direct manufacturer-retailer relationships, circumvention of the wholesaler cannot be feasible or economical. The most important of these conditions are a large size of order, a concentrated market, management capabilities, and the feasibility of using partial substitutes for the wholesaler's services. As is shown in the following discussion, several different circumstances may give rise to each of these conditions.

Large Order. If it is possible for a manufacturer to obtain from retailers orders involving substantial dollar amounts, then the marketing costs incurred in sending salesmen to call on stores, delivering merchandise to them, accounting for sales, and handling credit and collection problems may be relatively small. Such a condition may exist if the retailers are large-scale organizations, if they handle a very specialized line of goods, if the product is of high unit value, or if the manufacturer sells a wide line of merchandise.

Large-Scale Retailers. Chain store organizations, department stores, mail order companies, and other large-scale retailers ordinarily purchase substantial proportions of their total requirements of merchandise directly from manufacturers at advantageous prices, or through representatives other than wholesalers. They buy in large quantities, obtain quantity discounts, secure economies in transportation, and can store the product just as efficiently as a wholesale firm. In fact, savings frequently amount to more than

that, because they need not employ wholesale salesmen or create outlets for the goods they buy. Furthermore, large retail institutions are in a position to maintain an efficient buying staff and to secure favorable terms of credit.

While some manufacturers still refuse to sell direct to the retail trade even when goods are purchased in large quantities, because of resentment on the part of wholesale distributors, most of them recognize the chains and other large retailers and offer them merchandise at jobbers' discounts or even on more favorable terms. Retaliatory measures by wholesalers are sometimes taken against such manufacturers. The trend seems to be in favor of direct sale to all large retail enterprises, although a surprisingly large amount of merchandise is bought by even the largest retailers from wholesalers, sometimes as fill-ins and often because the retailers may not care to stock certain items in their warehouses.

Specialty Stores. Because specialty stores handle only a very limited variety of merchandise, their purchases are usually concentrated with a single supplier or with a few manufacturing resources, resulting in fairly large sizes of orders. If a store's business consists chiefly of one kind of merchandise such as men's coats and suits, typewriters, shoes, musical instruments, or cameras, the goods are bought by retailers, and consequently sold to them by manufacturers, in large quantities. Instead of buying a quarter of a dozen suits once or twice a week, a men's clothing store usually places several major orders per year. "Fill-in" orders may be placed by mail without any personal contact between the merchant and a manufacturer's sales representative. Essentially the same situation obtains in most stores that specialize in a very narrow line of merchandise.

Unit Value of Product. Numerous products are of such high unit value that only a few units of an item represent a sizable sale. Such commodities are often of a type that require a considerable stock investment by the merchant, service to be given in connection with sale or installation, and the maintenance of a stock of repair parts supplied by the same manufacturer. Examples of such products are automobiles, typewriters, pianos, major electrical appliances, furniture, and furnaces. Some of these products require such close working arrangements between retail dealers and manufacturers that exclusive agency agreements are made.

Yet even in the case of many such products the wholesaler occupies a strategic position. Many brands of major appliances, for example, are sold through wholesalers, on an exclusive agency basis. Such an arrangement permits the manufacturer to concentrate his efforts on manufacturing and demand-creation activities. Manufacturing schedules can be planned well in advance, because wholesalers often agree to market a certain quota. Wholesalers also may operate a central service station, thereby aiding dealers in their territory with repair business.

Size of the Line Produced. If the manufacturer produces complete lines or families of products, the tendency is to lessen the importance of the wholesaler. Individual orders from retailers under such circumstances are large enough to justify direct selling by the manufacturer. This is apparently one of the major reasons for the use of such a plan by the H. J. Heinz Company. This company is well known for its 57 varieties of merchandise (the actual number is now larger), although the bulk of the sales is made on relatively few items. Other examples may be found in the National Biscuit Company which produces a whole family of products, Sunshine Biscuits, Inc., Strictmann Baking Co., or Procter & Gamble Company.

In this discussion it is assumed that the line of products is more or less homogeneous or adapted to sale through the same retail outlets. Many factories, however, produce by-products which, though profitable, do not fit into their regular lines of merchandise. A paint manufacturer, for instance, may sell linseed oil meal—a cattle feed—which he secures as a by-product when oil is extracted for the paints he manufactures. Unless such a manufacturer is large enough to develop integrated channels for both the major products and for the by-products, wholesalers must usually be used for the marketing of at least one of them.

Concentrated Market. When the buying market for a manufacturer's products is highly concentrated, little travel expense is involved in retailer-manufacturer relationships and transportation economics may be realized. This may be attributable to a density of outlets or to the existence of a strongly developed central market which is visited by purchasers.

Density of Outlets. In the most populous metropolitan areas, large numbers of retailers in the same kind of business are situated in a confined geographic area. Such a concentration of customers may facilitate circumvention of the wholesaler, even in the distribution of convenience goods where transportation costs are an important factor and sales to retailers are frequent. There is such a large number of retail grocers or druggists in a city like New York or Chicago that a manufacturer may justify the establishment and maintenance of local warehouses to which merchandise is shipped in carlot quantities and from which prompt deliveries are made to retail stores. Because of the proximity of stores, salesmen may be able to make a large number of calls per day at reasonable cost. A manufacturer who pursues such a policy in major cities may find the wholesaler indispensable in sparsely populated districts where the costs of selling and delivery are too burdensome to justify direct distribution to retailers.

Location in Central Buying Markets. For many items of fashion merchandise, central markets are well developed and are frequently visited by retailers. Manufacturers located in such markets can make a substantial

volume of sales to retail store buyers while the latter are in the market. New York City is the leading market for almost all items of women's apparel, but Chicago, St. Louis, Dallas, Los Angeles, and San Francisco are also of substantial importance. Many manufacturers of furniture and house furnishings are able to sell direct to retailers without incurring much travel or selling expense by maintaining a selling office in the Merchandise Mart in Chicago which is an important market for such products.

Qualifications and Capabilities of Management. The management of the manufacturing enterprise may be well qualified and fully capable of coping with manufacturing problems, but may lack the facilities or the ability to deal with the numerous marketing problems incident to the performance of the wholesaling functions when selling directly to retailers. In such cases it may be wiser by far to confine operations to manufacturing and to let regular marketing institutions undertake the marketing task, unless the size and financial strength of the enterprise permit of an expansion in facilities and management for the proper integration of the two sets of functions.

Feasibility of Using Partial Substitutes for the Wholesaler's Services. If a manufacturer is well equipped to assume part of the wholesaler's functions, but not all of them, he may be able to utilize some special form of marketing organization as a partial substitute for the wholesaler.

Some manufacturers who find it desirable and feasible to maintain their own sales organization utilize public merchandise warehouses to handle the physical supply functions of wholesalers. Such warehouses are treated in detail in Chapter 23. In brief, they receive shipments from the factory, store merchandise, fill orders from stock, and handle deliveries to the manufacturer's customers. They are often operated in conjunction with a manufacturer's sales branch. When a contract is entered into with a public warehouse, there is no outlay of capital, no obligations for a lease are involved, and warehouse space may be contracted or expanded as warranted by trade conditions. Thus, warehousing offers an opportunity to manufacturers of certain goods who seek to go around the wholesaler to keep distribution within their own control.

Where there is no need for maintaining stocks of merchandise in local markets, the manufacturer may be able to utilize the selling services of one of the types of functional middlemen discussed in the following chapter. Each such middleman sells, on a commission arrangement, products of several manufacturers. In the furniture, men's furnishings, and sporting goods field, it is rather common for manufacturers to sell through manufacturers' agents. These middlemen sell more economically than the manufacturer, because they carry several different lines which they sell to the same trade. Orders are transmitted to factories and direct shipments are made to stores.

A few manufacturers utilize wholesalers primarily because of capital limitations which preclude granting credit to retailers on customary trade terms. If the customers are well-established organizations with good credit ratings, a special institution known as the factor might be utilized to finance customers' accounts. This institution is discussed in Chapter 25.

Performance of Wholesaling Functions by Retailers and by Manufacturers

When wholesalers are circumvented in the channel of distribution, the essential nature of wholesaling activities is clearly revealed. Whether the initiative is taken by retailers or by manufacturers, ways and means must be provided to perform the functions that would otherwise be rendered by independent wholesaling outlets.

Integration of Wholesaling Functions by Retailing Organizations. The extent to which retailers have attempted to perform the wholesaling functions when buying direct is difficult to estimate. The smaller retail organizations have generally passed on the wholesaling functions to the manufacturer, but the larger ones have attempted to perform these functions by establishing chain store warehouses or other places where reservoirs of goods are held until needed by the store.

A chain store warehouse is essentially a wholesale place of business. In many respects its operations are quite analogous to those of a regular wholesaler. It receives the goods, maintains inventories, breaks bulk, delivers and bills the merchandise to the retail units, and employs supervisors to inspect the stores and assist the store managers much as do the wholesaler's salesmen.

Reliable data on *total* costs of performing wholesaling functions in chain store warehouses are not available for any recent year from Census sources. For most types of wholesaling establishments it is known, however, that payroll expense usually amounts to about 50 per cent of total operating expenses; hence payroll costs may serve as a basis for comparison. In 1948, payroll expense reported for all classes of chain store warehouses amounted to 5.29 per cent of their total *sales and billings,* compared with 6.33 per cent for regular wholesalers.

The relatively lower probable cost of chain store warehouses may be explained by several factors. First, a large part of the goods included in "sales and billings," especially perishable items, actually moves direct from manufacturer or other supplier to store rather than to chain store warehouse. If the expenses were expressed as a per cent of the total goods actually *handled* in and through the warehouse, costs would no doubt be higher. Second, the chain store warehouse serves a captive group of cus-

tomers; hence there is no need for a sales force to solicit business from the retail units. Third, since the retail units are under the same ownership, it obviates any necessity for credit investigations or for collection expense. Fourth, delivery can be streamlined and made less frequently.

At the same time, a chain store warehouse undoubtedly incurs more so-called retailing expenses than does the wholesaler. Many such warehouses maintain personnel and accounting records for company retail stores, and much of the retail sales promotion and advertising work of the organization is performed by personnel employed in the warehouse office, which also often serves as administrative headquarters for the company or for a geographic division thereof. For these reasons, higher operating expenses may be expected for chain store warehouses. Inasmuch as chain store warehouses function very much like regular wholesalers in many ordinary respects and operate in the same kinds of locations with the same types of personnel and equipment, it is reasonable to conclude that whatever differences there are in total operating expenses probably issue from the distinguishing characteristics indicated above and not from a difference in the level of general operating efficiency.

Operating cost data for department store warehouses have never been collected and published, but it is known that many such establishments can be operated at a relatively low cost in comparison with the value of goods handled through them. As in chain store warehouses, there is no cost for selling or credit extension between the warehouse and the retail departments. A very large variety of items is handled, with the result that seasonal storage requirements of some merchandise are largely offset by different seasonal peaks in other departments. The rate of turnover and volume of business are such that fixed costs of operation are spread over a very large sales volume.

Integration of Wholesaling Functions by Manufacturing Companies. In lines of business where wholesalers are ordinarily an important link in the chain of distribution, most manufacturers have found it necessary to establish branch wholesaling systems in order to effect distribution *to nonintegrated retailers.* This usually takes the form of branches where stocks of merchandise are maintained, either in the manufacturer's owned or leased warehousing facilities or in space occupied in a public merchandise warehouse. Manufacturers' sales branches without stocks are only about one-half as important numerically as branches with stocks, and less than one-fifth of their total sales volume represents sales to retailers.[6]

Operating expenses of manufacturers' branches with stocks are generally somewhat lower than those of merchant wholesalers. In 1954, the average cost ratios for all lines of business were 10.5 per cent and 13.2 per cent of

[6] For data on number of establishments and distribution of sales, see Tables 17 and 18.

sales, respectively, for these two types of operation. Several reasons may be advanced to explain the lower cost ratios for manufacturers' branches. First, these establishments sell a much larger proportion of their goods to other wholesale organizations for resale than do merchant wholesalers. Such transactions ordinarily involve much larger quantities than sales to retailers and are accompanied by relatively low selling and handling costs. Second, the entire range of wholesaling functions is not performed in all manufacturers' branches. In many instances, some activities ordinarily performed by merchant wholesalers are performed in manufacturers' headquarters offices with the result that the cost of the activities, even though performed by the company, is not reflected in the operating costs of the *branches*. Illustrative are personnel management activities, sales promotion planning, often credit management and accounting, and other office work. Another factor is that manufacturers' branches are heavily concentrated in major metropolitan areas. For the most part, they do not attempt to call on retail stores in sparsely populated areas or on the smaller retail stores, wherever located, which are the most costly customers of regular wholesalers.

When the above conditions are given proper weight, it appears that sales branches would probably experience considerably higher operating costs than regular wholesalers, if strictly comparable activities were performed, similar services rendered, the same types and classes of customers served, and the same lines of merchandise involved in the same proportions. The only Census of Business classification of manufacturers' sales branches with stocks that is reasonably comparable with merchant wholesalers is the "food and kindred products" trade. Establishments here classified sell on a wide geographic basis, reaching a large proportion of the total retail grocery outlets in all classes of cities. In 1954, their operating cost amounted to 10.3 per cent of their sales volume, as compared with only 7.5 per cent for general-line grocery wholesalers. This reveals that the typical manufacturer with a branch wholesaling system must operate much like a specialty wholesaler, spreading costs over a small range of products in comparison with the regular wholesaler.

Conclusion. It is apparent that large-scale retailing organizations, partly because of diversity of products handled, are more favorably situated than are manufacturers—even those with fairly wide lines of merchandise—with respect to the assumption of functions of the regular wholesaler in an economical manner. Regardless of the direction in which the functions may be shifted in the channel of distribution, the fact that this is commonly done by providing specific establishments for the purpose (either chain store or department store warehouses or manufacturers' sales branches) is the most convincing physical evidence of the fundamental necessity of wholesaling functions.

QUESTIONS AND PROBLEMS

1. What motives commonly make manufacturers want to circumvent wholesalers? If the motives are quite strong in the case of a particular manufacturer, does this mean that a policy of eliminating wholesalers is likely to be successful? Explain.
2. How can you account for the decline of the independent wholesale distributor in the automobile trade?
3. How can you account for the limited sales volume importance of wholesalers in the distribution of men's suits or women's dresses? Does this mean that the proprietor of a men's or women's clothing store would not likely buy from wholesalers? Explain.
4. What are the principal conditions which make circumvention of the wholesaler feasible or economical?
5. To what extent may public merchandise warehouses or agents and brokers be regarded as substitutes for wholesalers?
6. Are manufacturers' sales branches with stocks altogether a substitute for employing regular wholesalers in distributing goods to retailers? Explain.
7. What happens to the wholesaler's functions and costs of performing them:
   a) When the manufacturer decides to sell directly to retailers without placing any additional burdens on the retailers?
   b) When the retailer decides to buy directly from the manufacturer without placing any additional burdens on the latter?

   Explain in detail, using available quantitative data in support of such explanation.
8. In which types of departments of a large department store may the buyers find it feasible to circumvent the wholesaler? In which types of departments may such a practice be unwise? Give reasons for the decision in each case.
9. The Smith Shoe Company manufactures high-grade ladies' shoes which retail at $19.50, $24.50, and $29.50 a pair. It uses only one retail outlet in a city except for New York and Chicago where there are two stores each handling these shoes. The company manufactures about 1,500 pairs of shoes daily. No sales are made through wholesalers. Instead, the company's salesmen sell directly to the retail trade. Why is it desirable and feasible to circumvent the wholesaler in this instance?
10. A certain cigar manufacturer feels that the wholesalers to whom he sells do not push his brand of cigars as much as other brands. Under what circumstances might the manufacturer be justified in his contention? Would it be feasible for him to consider eliminating the wholesaler and selling directly to retailers?
11. The X Company manufactures a line of toothbrushes, tooth powder and paste, handkerchiefs, hair nets, and an antiseptic mouth wash. Each of these products has been branded and advertised extensively in the leading magazines and over the radio. It has been the policy of the company to distribute its product exclusively through regular drug wholesalers. It has refused to accept orders from chain drug companies and department stores, informing such prospective customers that they can be supplied by local

wholesalers. It has also refused to sell to grocery wholesalers, rack jobbers, and to chain organizations in the grocery field, despite the fact that most of its drug wholesaler customers make little effort to call on the grocery store trade. Missionary salesmen have been used to a considerable extent to aid drug wholesalers. A survey indicates that sales of the company have remained stable in amount over a period of years, but that the company has lost substantially in terms of relative market position, because of growth in the total market. The sales manager proposes that more salesmen be employed to cultivate a wider market, that sales be solicited from all classes of wholesalers that sell the general types of products manufactured by the firm, and that direct sales be made to chain organizations and department stores which will buy in large quantity and accept delivery at a single warehouse destination.

What are the advantages and limitations of the proposed change in sales policy? Is the proposal sound? If you were the manager of a wholesale drug house, what would be your reaction to this new policy? Would you continue to handle these products?

12. The Sharpedge Tool Company is located in a large eastern city and manufactures many small woodworking tools which are sold to both carpenters and household users. As the company is small, its sales are restricted largely to an area with about a 150-mile radius. The products have been distributed through wholesale hardware houses to retail hardware stores. All products bear the "Sharpedge" brand which is not well known because the company has spent very little money in promotional work. This firm is dissatisfied with its present channel of distribution. Wholesalers are willing to carry the products, but sell them along with several well-known brands. They make no attempt to push the "Sharpedge" brand. Retailers likewise take a passive interest in these products. As a result, sales volume is far below that which the company would like to enjoy in the area which it serves.

Mr. Johns, president of the firm, feels that the company should hire salesmen who would sell directly to the retailers. The company has adequate financial resources.

You have been hired as consultant to advise this company as to the wisdom of such a change. What factors would you consider in determining whether or not the proposed method of distribution would be feasible? What would be your decision in this case? Would such a change be likely to lower or raise the costs of marketing this product?

16

MAJOR TYPES OF FUNCTIONAL MIDDLEMEN

Thus far the discussion of wholesaling manufactured consumer goods has been centered on the activities of merchant middlemen, i.e., middlemen who take title to the goods they distribute. A large and important sector of the wholesaling structure, however, is composed of middlemen who do not take title to the goods in which they deal and who are known as *functional middlemen, agent middlemen,* or as they are collectively designated by the Census of Business, *agents and brokers.*

General Nature and Importance of Functional Middlemen. Organizations falling within this group are known as functional middlemen since they specialize in only a limited number of the various functions which are necessarily performed in the wholesaling process. The most useful test as to whether a given middleman is a merchant or functional middleman hinges upon whether or not he *acquires title* to the goods he sells or distributes in the regular course of his operations. If he does, and operates in the wholesale field, he is a merchant middleman and falls within some one of the types discussed in Chapter 14. Absence of title ordinarily frees a middleman from a number of costly and laborious tasks, hence the use of the term "functional" with its connotation of limited functions and functional specialization.

Two main subdivisions of functional middlemen are agents and brokers, the distinction depending basically upon continuity of representation of the principal rather than upon legalistic grounds. As a class, functional middlemen have accounted for about one-sixth to one-fifth of total sales of

all wholesale establishments, with a tendency for this ratio to decline, as indicated by the following data:

Year	*Number of Agents and Brokers*	*Sales of Agents and Brokers as a Per Cent of Total Sales of All Wholesale Establishments*
1929	18,388	20.7
1939	20,903	19.4
1948	24,377	17.3
1954	22,131	15.9

The data on *number of establishments* do not indicate the *total number of agents and brokers;* and the sales volume ratios, while somewhat indicative of their competitive position, actually understate it. The reason for this is that the Censuses of Business for 1929–1948 were taken on the basis of recognizable business establishments, and the Census for 1954 was limited to establishments with paid employees. Many functional middlemen, especially of the type later described as manufacturers' agents and brokers, while accounting for a substantial volume of business, structurally are very small businesses, operated by individuals without paid employees and without a regular place of business in the ordinary sense. Such agents or brokers are not properly reflected in the Census of Business data on establishments.[1]

It is sometimes assumed that functional middlemen are utilized almost altogether to bridge the gap between the manufacturer and wholesalers handling his products or as a substitute for wholesalers. Such is not the case, for only a little more than one-half the business done by agents and brokers consists of sales to other middlemen for purposes of resale, of which about 70 per cent consists of sales to wholesalers and about 30 per cent to retailers. Sales to industrial users account for about 40 per cent of the total, and about 5 per cent is represented by sales for export. While some of the functional middlemen operate on the buying end of the business, by far the majority of them concentrate on the sales function; for this reason their business may be regarded generically as consisting of sales.

Additional light is shed on the operations of functional middlemen by the nature of products in which they deal. Approximately 61 per cent of their business is in manufactured goods, 34 per cent in agricultural raw materials, and 5 per cent in consumer farm products. Thus, while the present discussion is concerned primarily with the role played by agents and brokers in the distribution of manufactured consumer goods, it is not

[1] As an example, an analysis of the membership of the National Wholesale Furniture Salesmen's Association revealed that about 1,900 members of this group represented more than one manufacturer and operated as manufacturers' agents in 1950. By way of contrast, only 709 such agent "establishments" were enumerated in the 1948 Census of Business. See Thomas A. Staudt, *The Manufacturers' Agent As a Marketing Institution* (Washington, D.C.: Government Printing Office, 1952), p. 138.

possible to deal with their operations without some attention to manufactured industrial products and to agricultural commodities.

Selling agents provide the most complete range of marketing services, serving principals on a continuing basis and generally rendering all the services normally performed by a manufacturer's own sales force. Manufacturers' agents confine their activities to a particular territory, serve on a continuing basis, and perform functions similar to a manufacturer's salesman or a branch sales office. Commission merchants do not serve continuously but are engaged temporarily and intermittently for the disposal of specific lots of merchandise which are sold by them on a commission basis. Brokers are also temporary representatives, are engaged for the disposal or purchase of specific lots of merchandise, and serve by negotiating sales or purchases which are confirmed by principals before they become binding agreements.

There are, in addition, several other types of functional middlemen. Of considerable importance are auction companies, but because they deal chiefly in farm products they are treated in Chapter 18. Others sometimes referred to as functional middlemen are advertising agencies, purchasing agents, resident buyers, freight forwarders who render a transportation expediting service, and factors who aid in the financing function. Each of these is discussed in Part V of the book, in connection with the appropriate marketing function in which they specialize. Still additional classifications are export agents and import agents; since their operations are, by nature, not distinctly different from those of agents primarily in domestic trade, they are not accorded separate or special treatment in this book.

General Reasons for Use of Major Types of Functional Middlemen. Even though the major types of functional middlemen differ in the specific nature of the services which they render to manufacturers, they have certain common characteristics which indicate why they are employed in the channel of distribution. All the major types serve, at least to some extent, as a substitute for a manufacturer's own sales force. Most of them, however, serve a number of manufacturers of similar products or of products which are sold to the same types of customers. Through a process of combining several products or product lines, a functional middleman is usually able to spread the costs of operating a wholesaling establishment over a much larger sales volume than is possible for the manufacturer. Marketing costs are therefore lower in relation to sales volume. An important general reason for the use of functional middlemen is, therefore, economy.

Because of the low cost of selling through functional middlemen, manufacturers are often able to extend the radius of their operations. They can effect sales in distant and sparsely populated market areas that could not otherwise be served by their own selling organizations.

A third reason is that functional middlemen are specialists in marketing. Numerous small manufacturing firms producing a narrow line of goods are concerned chiefly with manufacturing problems. They are often perfectly content to allow others with a broader base of experience to assume a large amount of responsibility for the performance of marketing functions. In many plants, the sales volume is large enough to support only one executive, often the actual owner of the business, and he is usually a factory specialist not well qualified by education, training, experience, or interest to cope with the complexities and dynamics of market situations.

Fourth, all major types of functional middlemen are ordinarily compensated in the form of a commission or brokerage fee, which is in direct relation to the amount of sales volume produced on the manufacturer's line. Thus, to the extent that the manufacturer shifts marketing functions to such middlemen, he also shifts the costs of performing them. Marketing costs then assume for him a predetermined percentage relationship to sales. While this may involve large dollar sums expended for the services of functional middlemen in years when sales volume is particularly high, many manufacturers welcome such an escape from the continuing expense of attempting to hold a selling organization intact in years when conditions are adverse.

Selling Agents

Selling agents, as was previously indicated, perform the greatest variety of services of any of the functional middlemen and assume the highest degree of responsibility for marketing operations. Their importance is not always fully recognized, because in some lines of trade they are more frequently known as commission houses, selling houses, or by other similar terms. The variety of terms arises not so much from differences in functions as from historical usage in different trades.

Nature of Operations. A selling agent serves his principals on a continuing contractual basis, receives a commission for his services, does not take title to the goods, assumes responsibility for selling the entire output of his principal, gives advice on styles and patterns, furnishes financial aid, and assists in carrying or actually carries credits for the client.

Historically, selling agents have been most important in the textile trade, but their wide use in the sale of coal has created a second great field of activity. They also operate in a number of other lines, principal among which are metals and metal work, clothing and furnishings, grocery and food specialties, and construction materials, especially lumber.

Selling agents usually represent several mills or manufacturers producing allied and supplementary lines of goods of a noncompeting nature, although some confine their activities to the marketing of the output of a single mill.

When several clients are represented by a single agent the goods of the different producers need not be essentially different or noncompeting, but such is generally the case. Some selling agents are corporations that own, or are owned by, textile mill companies; in either case, they often also sell related products made by companies with which they have no ownership affiliation.

Functions. Services rendered by selling agents to any one client vary considerably, depending upon the individual arrangement governing the particular business relationship. Consequently, rates of commission vary greatly, depending upon the number of functions an agent is called upon to perform, nature of the goods, sales resistance that must be overcome, style risk involved, and the bargaining position and ability of the mill. Commissions for selling alone generally range from 2 to 5 per cent, with extra charges for additional services.

Selling. The principal function of all selling agents is to provide their clients with a selling organization for the disposal of their output. They frequently take orders several months in advance which serve as a basis for the mill's production schedule.

Selling is conducted partly from salesrooms maintained at different market centers, and partly through salesmen who cover the trade. Larger selling agents operate their business on a departmental basis, sometimes employing specialty, local, and traveling salesmen within a single department.

Styling. A second important function, and one closely connected with selling, is styling of goods. Mills producing goods of seasonal design find it essential to secure as much up-to-date style information as possible. This is a costly process when undertaken by a single manufacturer. Selling agents, by distributing their costs over several mills, are enabled to maintain representatives in all important style centers of the world and obtain authentic information on the latest styles, patterns, and designs, or to subscribe for such services. These representatives attend the best theaters, fashion shows and exhibitions, and fashionable society resorts and functions, for the purpose of observing what style leaders wear or how they react toward exhibitions by leading designers or couturiers. On the basis of such data, styles, designs, and patterns are submitted to clients, sometimes for adoption and sometimes only as suggestions subject to the exercise of the mill's prerogative. If the recommended designs are adopted, the mill makes up samples and submits its estimate of the cost of the goods. Designs for the season are then chosen and salesmen are sent out with the samples to secure orders.

Selling agents also furnish reliable market and price information for the guidance of the purchasing activities of mills. Some go even farther and supervise mill production and receive daily reports concerning production

progress on the various orders, on the theory that such information is essential to a proper correlation between production and selling. It not only makes possible intelligent direction of the sales force, but enables the agency to safeguard the observance of promises regarding delivery dates. When financial aid is extended, such data further help in checking up on the effective utilization of the loans.

Financing.[2] A third function of selling agents is to render financial assistance to the manufacturers they represent. It is a very important service when the clients are weak financially and far removed from the financial centers.

Credit and Collection Service. Finally, selling agents, particularly when they make direct loans to their clients or "cash their sales," often perform a complete credit and collection service. Under such circumstances they must approve all orders, which necessitates the maintenance of a credit department, and collect all accounts, thereby freeing the manufacturer from such work. Many selling agents guarantee all credits extended by them, render bills for the goods, receive payment and collect overdue accounts, and in turn remit to the mill after charges have been deducted, or remit the full amount collected and then bill the client for commissions and other charges.

When Employed. From the foregoing consideration of functions, it is apparent that the selling agent can be used most advantageously when the manufacturer operates on a small scale, needs financial assistance, produces a limited variety of products which require wide distribution, and when he needs continuous representation in the markets. Small-scale operation and a limited line may make the cost of sending one's own sales force over a wide territory at all times prohibitive. Brokers are best used when there is no need for continuous representation, and manufacturers' agents are best suited when sales assistance is needed for only a part of one's sales area and financial aid or styling assistance are not required by the manufacturer. Hence the selling agent fits into a place not well occupied by the manufacturer's own sales force, the broker, or the manufacturers' agent.

The principal disadvantages in using selling agents are, first, that the manufacturer is altogether dependent upon one outside organization for sales and, second, that it is sometimes difficult to coordinate manufacturing schedules with such an outside organization that sells for several different firms.

Manufacturers' Agents

Of the various other types of functional middlemen, the manufacturers' agent (or "manufacturers' representative" as he is popularly designated in

[2] This function, as well as that of credit and collections, is often performed, at least in the textile trade, largely by factors and hence is discussed at that point in Chapter 25.

some trades, but not to be confused with a manufacturer's sales employee) comes closest to approximating the variety of services rendered by the selling agent. In spite of some degree of similarity, there are nevertheless marked contrasts in the nature of the operations of these two types of agents and the conditions under which they are used.

Character of Operations. Manufacturers' agents sell a part of the output of two or more client manufacturers. Generally, they sell in a limited exclusive territory on the basis of a continuing arrangement with the manufacturer.

Manufacturers' agents differ from selling agents in the following major respects: (1) The territory of a manufacturers' agent is limited, while that of a selling agent is unlimited. Territorial size varies considerably, ranging from a single city in some instances to a combination of several states in others. (2) Manufacturers' agents have little, if any, control over prices, discounts, credit terms, or other conditions of sale, whereas it is common (although not universal) for selling agents to determine such matters. Manufacturers distributing through manufacturers' agents commonly carry on their own advertising and sales promotional activities, or determine the character of the advertising and selling work to be done by the agent. (3) While the selling agent undertakes to sell the entire output of his clients, the manufacturers' agent sells only a part of it, within the territory assigned to him, and according to some broader marketing plan usually pursued by the manufacturer in distributing through other agents assigned to noncompeting territories or through his own sales force in part.

Commissions received by manufacturers' agents vary considerably with the different lines of trade. For all such agents, average commission rates are about 6 per cent of sales. The range is from less than 2 per cent for commodities which are sold in very large volume and when sales are made with relative ease to more than 20 per cent for items which are usually sold in small amounts and when sales are accomplished with difficulty.[3]

Although nearly 4 times as numerous as selling agents, manufacturers' agents account for only 16 per cent more in volume of sales. The typical establishment is small, often consisting of a single individual, and only occasionally comprising more than several employees. A few agents operate on a considerable scale, however, and employ a large number of salesmen, each of whom is assigned to a group of specific accounts or to a specific sales area within the agent's territory. Larger agents sometimes represent as many as twenty-five different manufacturers and smaller ones as few as two or three. Their form of selling representation permeates almost all lines of manufacturing; but they are of greatest importance in the distribution of machinery and equipment, specialty groceries and foods, dry goods, electrical

[3] Thomas A. Staudt, *op. cit.*, p. 64.

goods, metals, clothing, apparel accessories, hosiery, furniture, and automotive accessories.

Functions. Most manufacturers' agents are concerned almost exclusively with the selling function, providing continuous sales representation for the manufacturer in the assigned territory. In addition, they are commonly a source of marketing information, feeding back to the manufacturer information on competitive conditions, product preferences, and suggestions for changes in styles and designs.

About 25 per cent of the manufacturers' agents provide warehousing facilities and make deliveries from stock carried on consignment from manufacturers. This is more common for agents operating in the industrial goods field than in consumer goods. Even then stocks are usually limited to items which must often be supplied on an emergency basis or to repair parts. In the majority of cases, drop shipments are sent by the factory directly to the purchasers, unless pooled cars are used, in which case the agent may take charge of the distribution of the goods after the carlot has been broken.[4]

When Employed. There are several circumstances which justify the employment of a manufacturers' agent. First is the financial consideration. Numerous manufacturing firms do not have adequate financial resources to establish their own sales organization, particularly when an extremely wide market must be covered. This situation obtains in the textile trades where some mills have grown in size and in financial strength sufficiently to free themselves from the selling agent but still lack the capital and experience necessary to assume complete control of all selling operations. Manufacturers' agents thus afford a desirable stage of transition.

Second, like other types of functional middlemen, manufacturers' agents are used by companies that produce a single product or a narrow line of goods with a unit value too low to justify the expense of maintaining a sales force.

A third favorable condition is when distribution is desired in sparsely populated territories or in markets located at a great distance from the factory. A manufacturing company may employ its own sales force for the disposal of its products in dense markets but may prefer to be represented by manufacturers' agents in sparse market areas where the volume of their possible business is small and traveling expenses are large. Distant markets present similar handicaps. This accounts for the fact that so many eastern and middle-western manufacturers, regardless of size, employ manufacturers' agents on the Pacific Coast. They thereby save the heavy traveling and living expenses that would be incurred by their own salesmen in crossing at definite intervals the vast expanses of mountainous and unproductive re-

[4] See Chapter 22 for an explanation of pool car shipment.

gions of the West and at the same time eliminate much idleness on the part of salesmen. A manufacturer located in the Far West is in a similar position with regard to representation on the Atlantic Coast, particularly when few commodities are produced.

Fourth, manufacturers' agents are used to advantage for introductory purposes. A manufacturers' agent may sometimes be employed as a means of securing entrance to a certain group of prospective buyers. He serves as a passport, a *billet d'entrée*. Finally, manufacturers' agents are useful where continuous representation in the market is needed and hence brokers and commission merchants cannot be employed to advantage, but where sales possibilities do not justify a full-time salesman.

While distribution through manufacturers' agents is commonly carried out under the above conditions, it nevertheless often presents some problems for the manufacturer. One of the most important is that of selecting agents who can provide the desired type of sales representation and who do not already represent competing manufacturers. A second problem is that of territorial assignments. The territory assigned to a specific agent must be integrated with the territory normally covered by him for other clients. It is quite a complex undertaking to make a selection of agents which provides complete selling coverage of the manufacturer's total market, without overlapping of territories. Third, since agents are independent businessmen, it is difficult to coordinate their activities and to have a group of them sell according to a manufacturer's planned marketing strategy.

Commission Merchants

By way of contrast with selling and manufacturers' agents, commission merchants and brokers are not ordinarily engaged on a continuing contractual basis, but rather for the disposal of a specific lot of goods or for a single transaction. While similar in this respect, commission merchants differ from brokers in other ways, particularly with respect to the freedom that they have in consummating a transaction and with reference to the actual handling of the goods involved in the transaction.

Nature of Operations. Commission men often have physical possession of the goods they sell, warehousing them or at least displaying samples of lots offered for sale, contacting potential buyers with a view to obtaining the best possible prices, and generally performing the sales function. They operate with considerably more freedom than brokers in that they have the power to accept an offer from a buyer without obtaining confirmation from the principal, although the principal often stipulates a minimum price in order to protect his own interests against possible abuse. In fact, the principal need not even be identified to the purchaser, for the commission mer-

chant makes the sale as if the goods were his own, extends credit at his own risk, renders a bill to the purchaser, collects the account, and submits to his principal an accounting of the transaction, together with remission of the proceeds less the commission charged for his services.

As the term "commission merchant" is used in this discussion, it refers only to firms that operate primarily in this manner, i.e., sell on a consignment basis goods to which they do not acquire title. Many commission houses actually blend this activity with merchant wholesaling by taking title to goods, a practice often criticized because of the opportunity it gives for abuse. As an agent of a principal, it is the function of the commission merchant to effect a sale at the highest possible price, whereas in purchasing on his own account such an operator is naturally interested in buying at the lowest possible price. Thus there is a definite conflict in interests when goods which are submitted by principals for commission sale are purchased by the commission man for his own account. When they buy on their own account with full knowledge of the fact by everyone concerned, there is not the same opportunity for abuse because the seller knows that he is dealing with a merchant whose interests conflict with his own and he must, accordingly, assume responsibility himself for making the best possible arrangement. Since the present discussion is confined to commission operations that constitute the bulk of the operations of particular wholesale establishments, the commission method of sale is more important. Many wholesalers who take title to most of the goods in which they deal operate on a commission basis to some extent.

Measured by sales volume importance, commission merchants constitute the second most important group of functional middlemen. Only about one-fifth of their total sales is in manufactured goods, about two-thirds consists of agricultural raw materials, and the remainder is in consumer farm products. For this reason, their operations are discussed in greater detail in the chapter dealing specifically with the marketing of agricultural products (see Chapter 18). In the manufactured goods field, commission merchants are of special importance in the wholesale dry goods trade and in the marketing of some grocery specialties, but are used only occasionally in the marketing of other manufactured products.

Factors Governing the Use of Commission Merchants. Commission merchants are used by sellers who need an immediately available outlet for the private sale of their goods, which can be consigned without advance arrangements and where shippers can be assured of immediate efforts to sell. Thus, with little effort and at no cost except on sales actually made, the manufacturer is enabled to draw upon an experienced sales staff in various markets. Manufacturers of goods which are highly standardized vary the procedure from that ordinarily employed by shippers of farm produce in

that they may not give the house physical possession of a shipment. Instead, samples, results of a chemical analysis, or grade specifications may be submitted, together with a description of quantities offered for sale and any limitations imposed upon the freedom of the commission operator with respect to minimum prices or delivery dates. Thus, commission outlets are well adapted to the sale of highly standardized products, since goods of that type can be more easily sold when not in physical possession of the seller.

BROKERS[5]

From the standpoint of sales volume, brokers are the most important type of functional middlemen. They operate, however, with the most limited freedom in consummating transactions and perform fewer costly functions than the other types.

Services of Brokers. The principal service of the broker is that of bringing buyer and seller together. He is a "go-between," assuming no title risks, and not being looked upon as a permanent representative of either buyer or seller. A broker does not take title to the goods in which he deals nor does he usually have physical possession of them. He does not handle the goods nor does he finance his clients. His is purely a negotiatory service or function. He finds buyers for merchandise under one set of conditions; under another he seeks out suppliers. In the first instance he represents and is paid a brokerage fee by the seller; in the second case he represents a buyer and is paid a fee by him. When demand is normal, the broker is more likely to represent sellers. But when supply is limited, or certain grades are hard to obtain, he more often represents buyers. Some brokers specialize in representing buyers, but most of them specialize in representing sellers. For 1954 the Census reported for these two categories 449 and 3,910 establishments, respectively.

When Brokers Are Used. Like other marketing institutions, the use of brokers is governed by certain well-established conditions which may be expressed in the form of marketing principles. First, when production is seasonal the broker is an efficient aid. Were he not used, the producer would be compelled to organize a sales force for work during a short selling season, discharge it when the task is finished, and rehire it the following year; else pay his men for an entire year but use them for but a part of the time. Either alternative would involve prohibitive expense. Brokers can be called upon when the product is ready for sale, used during that period, and be again ready the following year. They are immediately available and bring

[5] The discussion in this section is confined entirely to brokers who deal in merchandise or other tangible commodities except real estate. So-called insurance brokers, stockbrokers, or real estate brokers, are not considered in the treatment.

their knowledge of the market to the aid of the manufacturer for the time he needs it.

Second, brokers are useful when producers are small and the market is scattered. Since they are paid only when they serve their clients, and since they can be secured in all markets, a food processor may, by the use of brokers, touch all markets without establishing a sales force of his own. Similar conditions explain the use of brokers in the cotton piece goods trade. Here, many producers are small and not well financed, the market is very broad, and the broker is the ideal agent for reaching it. A third principle is that when goods are highly standardized and available from many sources, buying brokers are effective. Since they know all possible sources in detail, they render a special type of service by aiding the buyer to contact the best source of supply, without divulging the name of his principal until after the transaction has been consummated.

The economy of using brokers is suggested by the following typical brokerage fees: nationally advertised canned fruits and vegetables, 2 to 2½ per cent; less well-known brands of canned fruits and vegetables, 3 per cent; canned milk, 5 cents per case; woodenware items (e.g., toothpicks and clothespins), 5 per cent to 7½ per cent; frozen food products, 3 per cent to 4 per cent; sundries such as insecticides, 6 per cent to 7 per cent. Brokers are used in the distribution of all but a small per cent of the refined sugar sold in the United States. Specialized brokers who operate on a large scale in major metropolitan markets receive a commission of 5 cents per 100 lb. bag, but sales in many smaller areas are negotiated with the cooperation of two brokers, in which case a total brokerage fee of 8.75 cents is divided between them. In spite of the fact that the channel of distribution is unusually long, often involving two brokers between the sugar refiner and wholesale distributing organization, distribution costs are among the lowest for all food commodity groups. Total brokerage fees have been estimated to amount to less than 0.75 per cent of the final selling price of sugar.[6]

Brokers are, however, not always an ideal agency. Their principal advantage, that of being a widespread, quickly available and economical marketing institution, is in part offset by their somewhat impersonal interest in the transaction. To be sure, their fee depends on negotiating a deal successfully, but they are not laboring under quite the same incentive as is a manufacturer's own sales force. They are not subject to the same control nor the same stimulation. Some have their favorite producers and do not always give equal representation to all their clients. It is hard for a distant producer to know whether failure to sell in a certain market is due to the weakness of the broker or to his failure to quote the right price. But thousands of small canners and other small producers find it impossible to

[6] Jack T. Turner, *Marketing of Sugar* (Homewood, Ill.: Richard D. Irwin, Inc., 1955), pp. 122-25.

operate their own force and must depend on the broker; or if the goods must be handled or continuous representation is required, one of the other types of functional middlemen must be called into service.

The "Food Broker." The foregoing discussion has served to indicate the operations of most organizations known as brokers. The dynamics of marketing is illustrated by the fact that many firms, originally established and operated in this manner, and still known to the trade as brokers, have nevertheless altered their activities over the years in response to changing market situations. This is particularly true of "food brokers" who are members of the National Food Brokers Association, a group said to include more than 40 per cent of the brokers dealing in food products.[7] Members of this association have agreed upon a code of ethics and general operating procedures which distinguish them to some extent from other brokers operating in the food and other fields.

It is asserted that such brokers are actually manufacturers' agents or sellers' representatives. It is their policy to act only for sellers and to receive compensation only from them in any transaction. The position of such brokers as agents of sellers is explained in part by the fact that this has been customary practice in the food field, also undoubtedly by the influence of the brokerage fee provision of the Robinson-Patman Act,[8] which prohibits receipt of brokerage fees except for services rendered, which means that no fee can be received from a seller when a broker operates as a representative of the buyer, and vice versa. The question as to whether a "food broker" should be classed as a genuine broker or as a manufacturers' agent is a matter to be resolved in each individual case, depending upon the presence or absence of continuing contractual relationships pertaining to operation in a limited, exclusive territory. Actually, the operations of many *food* brokers bear a closer resemblance to those of manufacturers' agents than to what may be designated as *bona fide* brokers.

Such a food broker, in addition to representing only sellers, confines his activities to a definite territory which usually consists of the wholesale grocery trading area of the key city in which the office is maintained. Within this territory the broker is ordinarily the sole sales agency of the principals who engage his services, and he serves them by negotiating sales with grocery wholesalers, chain store buyers, and institutions. He receives commissions on all sales made by the principals within the broker's specified territory regardless of how the sales are actually effected—an arrangement

[7] For a more complete description of the operations of food brokers, see Urban A. Shirk, "Evolution of the Food Broker," published as chap. xi in Paul Sayres (ed.), *Food Marketing* (New York: McGraw-Hill Book Co., Inc., 1950); and, *Merchandising Service and the Food Broker* (Washington, D. C.: National Food Brokers Association, n.d.).

[8] The provisions of this Act are explained in Chapter 36.

justified by the merchandising service rendered by such brokers and which, in some instances, is highly developed. Many of the food brokers now have a "missionary" sales staff that calls upon independent retail stores and units of chain store organizations. While the broker ordinarily transacts business with wholesalers and chain store buying offices, his missionary salesmen solicit orders from new retail accounts; the orders are then turned over to merchant wholesalers who maintain stocks, provide delivery service, and render other wholesaling services. The merchandising service also includes the activities of explaining the manufacturers' advertising programs to retailers, soliciting dealer cooperation in local advertising, getting the dealer to use point-of-sale advertising material, and arranging for store and window displays of the principals' merchandise. Because the broker's missionary sales staff works with the products of several manufacturers, this can be done at lower cost than experienced by most manufacturers who attempt to organize comparable merchandising services for themselves.

QUESTIONS AND PROBLEMS

1. What are the important general reasons that account for the widespread use of functional middlemen in the channel of distribution for many commodities?
2. Do data from the Census of Business fairly reflect the quantitative importance of functional middlemen in our economy? If not, does your explanation apply equally to all of the major classes of functional middlemen discussed in this chapter?
3. Outline the major points of contrast between:
   a) selling agents and manufacturers' agents
   b) commission merchants and brokers
   What similarities are involved in each case?
4. In spite of the fact that manufacturers' agents are much more numerous than selling agents, the amount of business they do as a class is not commensurate with their numerical superiority. How can you account for this situation?
5. From the viewpoint of the manufacturer, what major problems are associated with distribution through each of the four major types of functional middlemen?
6. Explain the logic of and justification for each of the following excerpts taken from the "Code of Ethics" of the National Food Brokers Association:
   a) "The Food Broker's function requires that he shall be unfettered by affiliation with any buyer or purchasing agent . . ."
   b) "The Food Broker . . . cannot offer faithful service to the 'seller' and unbiased guidance to the 'buyer' if his actions and opinions are warped by the ownership of food products in which he deals."
7. The X Manufacturing Company produces a limited line of automobile parts and accessories. Its plant is located near Detroit and about 40 per

cent of its output has been taken by one car manufacturer. Realizing the inherent instability of the situation, the management would like to tap the replacement market of the Rocky Mountain and Pacific Coast regions but does not have the resources to employ and train a large sales force to cover this area. As a marketing consultant, you are called in to study the problem. Indicate all possible alternatives, your recommendations, and reasons for your conclusion.

8. A small textile mill in the New England states is manufacturing drapery yard goods which it sells directly to department stores and to furniture stores with drapery departments. It maintains a small New York office and keeps a skeleton sales force which calls on large customers. This selling organization is deemed costly in light of the company's sales volume and is not satisfactory as a means of selling the company's products. How would you suggest that this textile mill dispose of its products?

9. The Thomsen Canning Company is a relatively small tomato canning firm. The company has prospered in recent years, and is in excellent financial condition, with a large surplus of uninvested capital. Up to the present time, the entire annual pack has been sold to several large food chain organizations. Sales arrangements have been made by Mr. Thomsen, the President and principal owner. The entire production has been packed under the private label of the company's customers. There is no sales organization, and the company has never used any outside marketing assistance.

   In recent years, population has been growing rapidly in the five-state area in the midst of which the company is located. Mr. Thomsen believes that there is an excellent opportunity to expand his production facilities, to bring out a line of canned tomato products under the company's own brand, and to sell them widely throughout the five-state area that can be reached with low transportation costs. After making an analysis, he was surprised to learn that there were actually several hundred prospective customers within this area (grocery wholesalers, chain store warehouses, and large institutions).

   If the plan to expand the company is carried out, what channel of distribution would you recommend? Explain your reasons in some detail. If your recommendations were followed, what major problems would Mr. Thomsen encounter in putting them into effect?

10. The Williams Food Products Company wishes to add a new item to the list of breakfast food products which it manufactures, but it is not in a position to carry on the promotional and sales effort necessary to assure its successful distribution. Explain how this may be accomplished by use of a functional middleman.

11. A critic of our marketing system pointed out that costs of distribution were unnecessarily increased by the addition of middlemen to the channel of distribution. He complained that the retailer gets a substantial margin, the wholesaler does also, and then all sorts of other middlemen such as manufacturers' agents, brokers, and selling agents, also get a "cut" of the consumer's dollar. He advocated the elimination of such "behind the scenes" middlemen, with the suggestion that marketing costs would decline and consumer values increase if they were not permitted to participate in the marketing process. Evaluate this line of reasoning.

17

WHOLESALING OF MANUFACTURED INDUSTRIAL GOODS

In the preceding chapters the discussion was concerned principally with the operations and services of various types of wholesale middlemen engaged in the marketing of manufactured consumer goods, i.e., goods destined for resale to ultimate or household consumers *in the same form* as they leave the factories or processing plants. It will be recalled that wholesaling has been defined as consisting essentially of *all* marketing transactions in which the purchaser is actuated solely by a profit or business motive in making a purchase, as distinguished from retailing in which the purchaser is motivated by a desire to satisfy personal wants. Thus, an extremely important part of the wholesaling structure, and one which has not been covered in the preceding treatment, consists of the marketing of goods to others than ultimate consumers.

Industrial Marketing Defined. Industrial marketing consists of the marketing of goods which are used in producing consumer goods, other business or industrial goods, or business or personal services, or which facilitate the operation of a business enterprise. Thus, the term covers the marketing of all goods which are to be converted into more finished products or services; all machinery, equipment, parts, and supplies used in making such conversion; and all goods entering into the process of production whether the purchaser be a farmer, a manufacturer, a construction contractor, one engaged in a service industry, a retail or wholesale organization, or a governmental purchasing agency. The final test is, therefore, whether the goods are bought for industrial or business use or for final resale to ultimate consumers *in the same form* in which they were purchased. *All goods bought*

for industrial or business use are industrial goods, and the marketing of them represents industrial marketing.[1]

Industrial goods are purchased by a large number and variety of concerns, operating in diversified fields of endeavor. Among these are the manufacturing industries, the mines and quarries, the construction industry, hotels, restaurants, theaters and other places of amusement, personal service industries such as barber shops and beauty parlors, mechanical repair services, such institutions as hospitals and schools, governmental organizations, the transportation industries, banks, communication industries, retail stores, and wholesale places of business.

It is probable that there are more than 4 million establishments in these various fields buying some goods for business use, rather than for the personal use of the buyer and his family or for resale in the same form. The magnitude of the industrial market can hardly be overemphasized. About 45 per cent of all manufactured goods is sold for industrial use. Four-fifths of all farm products, the entire production of crude petroleum, the bulk of the products of mines and quarries, all the products of commercial fishing and hunting and of commercial forests, and about one-half of imported goods are also a part of the industrial market. There is, of course, much duplication in statistics designed to disclose the total market since many products enter into it more than once.

Types of Industrial Goods. Special problems incident to the marketing of the various types of industrial goods are treated in detail in a following major section of the chapter. Each of the various types of industrial goods is, however, defined briefly at this point, in order to provide a clear picture of the total industrial market before examining its general characteristics.

Installations. These include major items of production equipment which are usually regarded as a part of the fixed plant of the purchaser. Illustrative are electrical generators, Diesel engines, steam boilers, lathes, punches and shapers, looms, papermaking machines, printing presses, ceramic ovens, air conditioning plants and vertical transportation facilities for stores and office buildings, and similar items. They are normally purchased only after very careful planning based upon technical advice.

Equipment. Factories and other business establishments use a variety of equipment items which are not so vitally important as installations and which are usually not regarded as a part of fixed plant. One type supplements installations and includes such items as portable electric drills, vacuum

[1] For a more complete discussion of this subject, including an evaluation of alternative approaches to defining industrial marketing, see T. N. Beckman and N. H. Engle, *Wholesaling—Principles and Practice* (rev. ed., rev. printing; New York: The Ronald Press Co., 1951), chap. xi.

sweepers in a hotel, press feeders in a print shop, display fixtures in retail stores, or spotlights in a theater. Another class is facilitating equipment such as typewriters, adding machines, signal systems, time clocks, small motors, electrically operated trucks, and even wheelbarrows.

Semi-Manufactured Goods. Many products represent the finished output of one industry but are subject to additional changes in form in the manufacturing processes of another. Examples are leather, sheet and structural steel, pig iron, copper, lead, flour sold to bakeries, chemicals, yarns, textiles sold to garment manufacturers, lumber used by furniture manufacturers and by building contractors, gold for the dentist, and cement for the road contractor. Many such items pass through several production stages in different factories before they finally enter the consumer goods market.

Parts. This term is used to refer to a class of manufactured articles which can be installed as a part of a larger product without further processing; also repair or replacement parts. It covers such products as small motors for electrical appliances, radio and television set tubes, castings supplied by a custom foundry (often from molds owned by the purchaser), assembled valves, automobile tires and tubes used as original equipment, molded plastic parts, antifriction bearings, hydraulic brakes, and carburetors.

Supplies. Items which are essential to business operations, which are consumed in a short period of time, and which are generally regarded as highly expendable are called supplies. Illustrative are lubricants, light bulbs, sweeping compound, paper, office supplies other than those classed as equipment, test tubes for the chemist, and tooth powder used by the dentist in connection with his professional services. Small tools of low unit value which are replaced frequently, such as pliers and screwdrivers, are often classified with supplies.

Raw Materials. Raw materials include the products of the farm which are processed before being consumed, such as cotton, wool, the grains, most of the livestock, tobacco, coffee, milk, and such fruits and vegetables as are sold to canners, together with the products of the mine, the forest, and commercial fishing. This term is limited to the primary or basic raw materials and does not include any of the semi-manufactures which are sometimes erroneously classified under this heading.

Some Products Have a Multiple Market. The foregoing classification serves to group industrial products into fairly homogeneous classes, to indicate the broad scope of industrial marketing, and to permit treatment of specialized problems that exist in the marketing of different types of products. It must be used with one important reservation in mind, namely, that products have been classified according to their use, or the manner in

which they are regarded by users, not according to inherent technical or physical characteristics. For this reason, many products may, under varying circumstances, fall into more than one of the classes just indicated and may even be sold in the same form as consumer as well as industrial goods. Light bulbs, for one example, are purchased as consumer goods and as industrial goods, and within the industrial goods field they are used as supplies or as parts by manufacturers of floor lamps and store lighting equipment.

Characteristics of the Industrial Market[2]

The industrial market differs in a number of important respects from the market for goods sold to ultimate consumers. Because of the diversity of industrial products, generalizations do not, of course, apply with equal force to all kinds and types of goods entering the industrial market. The present discussion is confined to features that are so widely prevalent that they may be deemed generally characteristic of this market in contrasting it with the consumer goods market, even though some exceptions may be encountered under specific circumstances.

Size of Purchase by Customers. One essential difference is the size of purchase. Ultimate consumers buy one unit of an item or a few units at a time, and their maximum outlay for tangible goods other than real estate is generally for an automobile. Installation sales, on the other hand, often involve dollar amounts in six digits. Many items of industrial equipment involve the expenditure of thousands of dollars. Contracts for parts, semi-manufactured goods, and raw materials often involve many thousands and sometimes millions of dollars.

Limited Number of Customers. A further characteristic of industrial marketing is that the possible number of customers for a given product is often very limited. When an industrial product is used only by one or a very few industry or trade groups, it is said to have a *vertical market*. The market is narrow, but deep in the sense that most prospective customers in the industry may need the article. Machinery especially designed for shoe manufacturing or for textile weaving is illustrative. In a few cases, a vertical market may be limited to less than ten possible customers, but in other instances it may amount to thousands. Manufacturers of dress trimmings have a vertical market, but there are approximately 4,000 dress manufacturing establishments that have use for such items.

[2] For a more detailed description, see report of Industrial Marketing Committee Review Board, "Fundamental Differences Between Industrial and Consumer Marketing," *The Journal of Marketing,* October 1954, pp. 152-58; also, Ralph S. Alexander, James S. Cross, and Ross M. Cunningham, *Industrial Marketing* (Homewood, Ill.: Richard D. Irwin, Inc., 1956), chap. i.

A *horizontal market* exists when the product is bought by many kinds of firms in different industries. Most supplies fall in this category, for almost all firms have need for products such as paper towels, small tools, stationery, light bulbs, nails and screws, etc. Office machinery, materials handling equipment, and cleaning and maintenance equipment are further examples. While a horizontal industrial market is usually very broad in comparison with a vertical market, numbering perhaps hundreds of thousands or even more than a million possible users, such a market is nevertheless limited in comparison with markets for ordinary consumer goods, where possible purchasers are counted in terms of tens or hundreds of millions.

Purchase on Performance Basis. Because of the nature of the materials, purchases are usually made on a performance basis, with rational buying motives governing the purchasing decision. Before a certain machine is installed, accurate knowledge of just what it will do under different manufacturing conditions must be obtained. Installations may be bought on specifications developed by the industrial user, or after a careful comparison of the merits of alternative products. Raw materials are subjected to careful tests to determine their suitability for specific uses. Industrial goods generally are sold on the basis of more complete and more precise descriptions than are employed in the case of consumer products. Prices usually fluctuate within narrower ranges than is characteristic of consumer goods, because buyers are not emotionally motivated by consumer marketing stratagems such as loss leaders, special promotional sales, or month-end clearances. Obsolescence in industrial goods is governed more by the criteria of utility and use costs. The impact of fashion and style, which are very important in consumer goods, are less significant in industrial marketing, except insofar as the demand for certain materials is derived from fashion change in consumer goods products.

Diffused Buying Responsibility. Marketers of consumer goods accept the housewife as the primary source of responsibility for consumer goods purchasing, recognizing, however, that she is influenced by the wants and needs of other family members. Middlemen in consumer goods channels have little problem in determining who is responsible for purchasing on the wholesale level. Wholesalers soon learn who buys for each store they serve. But industrial purchases may result from any one of a number of factors and from any one of several officials. The factory purchasing agent occupies a role which has no counterpart in consumer goods, but salesmen of industrial lines know that in thousands of companies he has little influence in determining what brands or quantities shall be purchased other than for routine supplies. Installations are made after careful investigation of the merits of rival lines by the plant engineer, the superintendent, sometimes by foremen, and often by the president and the board of directors. Consulting

engineers and architects influence decisions to buy certain products. Equipment is often selected because of the personal wishes of a foreman or plant superintendent. Toolroom foremen exercise a decided influence, for they are able to speak of the merits of lines used in the past. Reciprocity must be considered, and officials often have personal acquaintances who are to be favored, at times even against the best judgment of the purchasing agent.

One problem for the salesman of industrial goods is to ascertain the most influential officials in a company insofar as buying is concerned. Time is wasted talking to the superintendent who has no power but will not admit it. What he learns at one plant may not help greatly in the next call in the same industry, since policies vary with the personalities of the various officials. Likewise it is difficult to avoid waste in direct mail as well as in periodical advertising when neither advertising nor sales managers can determine who are the most probable prospects.

Reciprocity.[3] Another definite characteristic of industrial marketing is the importance of reciprocity policies. Many companies believe that they should give their customers preference when in the market for articles of the class produced by them. Thus the railroad gives preference to the brands of the oil companies which use its services and to the steel-making companies whose mills and mines are served by the road. Officials of some tire companies have been asked to buy automobiles from manufacturers using their tires for original equipment. While there are occasional instances of purchasing on the basis of reciprocity in the consumer goods field, this is known to be much less significant than in industrial marketing.

Demand Fluctuates Widely. There is no demand for industrial goods *per se*. In this market demand is altogether derived from the demand for consumer goods or services that flow from the production and marketing of industrial goods. In depression periods the industrial market absorbs a smaller proportion of the total goods produced because the lower level of consumer goods production can be maintained without adding to existing productive equipment. In boom periods, the demand for industrial installations and equipment, and for semi-manufactured goods and parts that enter into their production, is greatly accelerated. As ultimate consumer demand reaches high levels, additions are made to existing productive equipment which far surpass normal replacement demand. Producers of industrial goods then have few sales problems because industrial purchasers are seeking equipment and materials almost regardless of price and sometimes even of quality. Delivery dates may be the most important patronage motives. Under adverse general business conditions, it is almost impossible to make sales except in the most limited quantities.

[3] For an evaluation of reciprocity in purchasing, see Chapter 19.

Discovering the Market. In comparison with industrial goods, the potential market for most consumer goods items is easily defined in terms of persons and families with certain income, type of residence, sex, age, or other characteristics. Furthermore, such markets are relatively easily located geographically by means of Census of Population information or market surveys. By way of contrast, manufacturers of industrial goods are faced with the constant problem of discovering new uses of their products by old customers and additional outlets in other industries in order to maintain or increase sales volume.

In developing markets for silicones, a leading manufacturer had to engage in extensive research to discover possible applications, determine which applications were feasible from a cost standpoint, and then acquaint prospective users with the research findings. Among the applications successfully developed were "Sight Savers," a pad of silicone-treated tissues used for wiping eyeglasses; a silicone coating which bakers use to coat pans to eliminate greasing between each baking; and a silicone fluid used on apparel items to make them water repellent.

The market for pressure-sensitive tape is estimated to have grown five to six times in the ten-year period following World War II, because of new applications discovered by manufacturers of this type of product. Among numerous interesting applications are included the familiar masking tape widely used in automobile painting; holding tapes, used to keep doors of major appliances from coming open in transit or in warehouse handling; strong bond tapes, used in place of wire or steel bands in reinforcing fiberboard cartons; sealing tapes, to keep dust and moisture from packed mechanical items; and printed or colored tapes, used for identification of products or to distinguish parts of complex installations, such as oil from water lines.

In essence the problem of all industrial marketing research, and it is not a simple one, is one of discovering who uses the product, what is it used for, what conditions surround its use, what are the trends in demand for the products of which it is a part, what new applications are feasible, what are competitors offering, and how well the product in question is meeting the needs of its users.

Marketing Channels for the Distribution of Manufactured Industrial Goods

In the distribution of industrial goods produced in the factories, four principal classes of channels are utilized, as follows:

1. Direct from factory to user
2. From factory, through the manufacturer's own sales branches, to user

3. From factory, through agents or brokers who do not take title to the goods, to the industrial user
4. Through industrial distributors (wholesalers)

Different combinations are sometimes employed. Some sales are made from sales branches to industrial distributors, and occasionally a functional middleman serves as a connecting link between a factory and the industrial distributor. These are not common situations, however, as the great bulk of the products sold by industrial distributors is moved by a direct channel from the factory to user.

It is estimated that about 60 to 70 per cent of manufactured industrial goods moves directly from factory to user without the aid of functional middlemen or a manufacturer's branch wholesaling system; about 17 to 20 per cent is handled through wholesalers or industrial distributors; about 12 to 15 per cent is distributed through manufacturers' sales branches; and from 10 to 15 per cent of the total shown by the above distribution is made through functional middlemen.

In the paragraphs that follow, consideration is given to factors which generally govern the use of these channels in the industrial market. This is followed by another major section in which special marketing and distribution problems associated with specific types of industrial goods are treated in some detail.

Direct Sale to Industrial Users. Much of the industrial market is composed of expensive but technically complex machinery and installations. Because expert advice is often necessary to determine the needs of the consumer, and in some cases specifications for the manufacture of special products must be drawn by the salesman, wholesalers' representatives having a large line of products are not well fitted for such sales. Demonstrations call for special knowledge possessed only by men trained in the qualities of one line of machinery. Since many such products are of high unit value, direct contact is economically justified.

A second factor favoring direct sale is that a highly concentrated market exists for many industrial products. Manufacturers selling to a horizontal industrial market consisting of all manufacturing industries find it significant that nearly one-half of the total number of manufacturing establishments are located within about one per cent of the total number of counties in the United States. Various vertical markets are much more concentrated than this. Manufacturers of machinery and equipment used in shoe manufacturing find a considerable proportion of the largest producers concentrated in four areas, around Boston, St. Louis, in central and southern Ohio, and in Tennessee. Those who sell to the automotive industry find most of their customers in the Detroit area, while sellers to tire companies

will find the major producers located in Akron. Numerous additional examples could be cited of industries where all or a large proportion of the potential customers can be reached by sending salesmen to a very limited number of locations.

While such geographic concentration is a great convenience, simplifying the problem of direct selling, it also presents complications. The nonconcentrated portion of the total market is very widely dispersed, sometimes necessitating a supplementary plan of less direct distribution in order to cover it at reasonable marketing cost.

The size of orders is a third factor which determines the use of direct sale to the industrial market. Since quantity buyers desire to secure prices based upon their large purchases, it is natural for them to prefer to buy directly from the producer. Furthermore, the expense of maintaining a direct sales force is relatively small when orders involve very substantial dollar amounts.

Sales Through Wholesale Branches. Manufacturers who operate wholesale branches as sales headquarters in territories where their product is most in demand are simply using a modified form of direct selling. Perhaps it should be so classified, but since branches often carry stock, provide mechanical service, make engineering advice available, and are able to maintain closer relations because of their proximity to prospects and customers, this form of selling deserves a special classification.

Such branches are often established by large and well-financed manufacturers whose customers are located in different parts of the country, but in sufficient numbers in different local areas to justify the expense of operating a branch wholesaling system. Branches usually consist merely of an office headquarters for a district or regional sales organization when products are of a high unit value and technical character, are manufactured to the specifications of customers, or are sold in very large quantities that are anticipated well in advance by purchasers. When the manufacturer sells items of widespread application which are often purchased on an emergency basis, or when users have alternative local sources of supply, branches usually include warehousing facilities. Such stocks may be maintained in an establishment operated by the manufacturer or in public merchandise warehouses. Branches are most commonly used under conditions favoring direct distribution, but where distance, communications, and delivery difficulties preclude operations from the factory.

Selling Through Industrial Distributors. Industrial distributors are wholesale merchants, operating in the main like regular wholesalers engaged in the distribution of consumer goods, although differing from them in the

goods handled and in the customers served.[4] Industrial goods, principally standard equipment and parts, tools, and supplies, constitute their stock.[5]

Their function is more clearly understood through such terms as "supply and machinery distributor," "machinery dealer," "mill supply house," and "mine and mill supply house," which are often used to refer to the industrial distributors selling to horizontal markets. Other terms applying to industrial distributors in various vertical markets are beauty and barber supply house, dental supply house, laundry and dry cleaning supply house, undertakers' supply house, railroad equipment dealer, ship chandler, and hotel and restaurant "outfitter."

In general, the industrial distributor renders services to both seller and buyer similarly to the wholesaler in other lines. One service is that of acting as a purchasing agent for his customers. A mill supply house may have a stock of 5,000 to 6,000 items even when it serves only one line of industry. Stocks of 40,000 to 50,000 items are not unknown in the case of distributors who have members of several industries as customers. They watch the offerings of manufacturers and attempt to forecast the needs of their customers by carrying wanted items in stock. To do this they are forced to choose from the offerings of many manufacturers, even hundreds or several thousand within some particular product classifications. All the items assembled by the distributor are consolidated into one catalog, a notable convenience to the industrial purchasing agent.

Other services of interest to customers include the ability of the distributor to buy in large quantities with resulting transportation economies, thus often making possible the quotation of lower selling prices than could be obtained if goods had to be purchased direct from manufacturers. Stocks are maintained close to customers' plants. This facilitates buying and often prevents heavy losses through the ability of the distributor to prevent plant shut-downs by the quick supply of vitally needed articles. Customers also gain by reducing their inventory of repair parts if a reliable distributor maintains a complete stock. By pooling the reserve for many customers, a smaller total stock is needed.

Distributors' salesmen are trained to give technical advice to customers. Some of them may be better engineers than those employed by the buyer's plant, for they have acquired special knowledge through serving many customers. They inform customers of the newest products and their relative merits, indicate when and what savings a customer will be able to make by installing new equipment, and often help in solving specific problems

[4] Many wholesale hardware merchants have an industrial department with a sales force organized separately from that calling upon the retail trade.

[5] Typical of the more common products generally handled by industrial distributors are cutting tools, hand and electric tools, compressors, pumps, pipe, valves, fittings, rope, cordage, bolts, nuts, screws, belts, packing, hoists, paint, brushes, grease, abrasives, and steam specialties.

vexing the buyer. Since such salesmen can be more specialized as to line than the purchasing agent, their advice on probable market changes is often eagerly accepted.

Like other wholesalers, industrial distributors often finance their customers by favorable credit terms. It is far simpler for a purchaser to establish credit with a few distributors than with many manufacturers. Accounts also are correspondingly simpler. Finally, the distributor's policy of protecting his customers on goods sold to them means more than do the guaranties of some manufacturers.

Industrial distributors serve their sources of supply by providing a competent sales force, one that can call on a larger number of customers more frequently than is feasible for direct selling manufacturers. One survey revealed that the "typical" industrial distributor employs 5 salesmen, each of whom makes about 8 sales calls a day and serves about 145 accounts. Thus, the typical distributor represents about 40 sales calls each working day, among 725 customers.[6] An industrial goods manufacturer selling through a network of some 200 noncompetitive distributors located in different cities would make his product potentially available to about 145,000 distributor customers. Visualize the task of the manufacturer of industrial brooms, belting, lubricating oil, or roof paint were he to call on all possible users, a number coextensive with industry itself.

Another important service to the manufacturer is that of storing goods near the point of demand. Since the manufacturer, by use of distributors, greatly reduces his number of direct sales contacts, his credit and accounting problems are proportionally simplified. When one thinks of the services of the industrial distributor to both buyers and sellers, one is led to conclude that he fills an important niche in the scheme of industrial distribution and that he has a secure place so long as he continues to serve efficiently.

Functional Middlemen. Selling agents in the industrial field serve much as they do in consumer goods lines. They take over the entire sales task for a manufacturer. They organize a sales force, train and supervise it, and sometimes assume the risk of credit. Often, especially in textiles, they furnish important merchandising and style advice. The manufacturer's task then becomes that of efficient production, to the end that his selling agent may be able to quote competitive prices.

Manufacturers' agents are more common in industrial marketing. They represent a variety of producers of equipment, parts, and supplies and sometimes also those supplying basic machines or installations. Like his counterpart in the sale of consumer goods, he is particularly useful when customers are remote or widely scattered. Since he represents several manufacturers, he can pool both his efforts and his expenses.

[6] "So You Have a Product to Market," undated brochure published by *Industrial Distribution* magazine.

Brokers are found in markets for semi-finished and highly standardized products, such as industrial chemicals, the metals, essential oils, cloth "in the grey," just as in many raw materials markets. Their method of operation and the reasons for their use do not differ materially from those already discussed in a previous connection and in the chapter immediately following.

Retail Stores as Outlets for Industrial Goods. A small proportion of industrial marketing, but one accounting for large annual dollar amounts, consists of retailers' sales to industrial or business users. Retailers play a significant role under three principal circumstances, as follows: (1) when the goods in question have widespread use both in the ultimate consumer and business markets, as is the case with many items sold in stationery and office supply stores; (2) when the business purchaser is quite small, illustrated by supermarket sales to operators of small restaurants, hardware store or retail lumber yard sales to building contractors or agricultural producers, and paint and wallpaper store sales to painting contractors or interior decorators; and (3) when the business purchaser has only occasional need for the items in question. Practical difficulties preclude attempts to separate such transactions from sales to ultimate consumers.

Marketing Different Types of Manufactured Industrial Goods

General reasons have been advanced for the use of different channels of distribution in the industrial market. The circumstances favoring each of these channels do not, however, obtain with equal frequency or force in the various segments of the industrial market. Furthermore, there are other differences in marketing problems and policies associated with the distribution of the various types of goods.

Marketing Installations and Equipment. These two types of goods may be considered together as one broad category, because both consist of products with a relatively high unit value and both require substantial investments by purchasers. In addition, many products in both classes are extremely technical and complicated. Such items are generally purchased only every 10 or 20 years, unless required for expansion purposes or unless obsolescence becomes an overriding factor. They are usually bought on the basis of projected cost analyses, taking into account the estimated useful life of the equipment, allowable expense charges for depreciation, costs of operation and maintenance, and other relevant considerations.

Manufacturer-to-User Channel. Direct sale is the predominant method used in distributing machinery. Technical knowledge is needed and in general the market is too specialized for the use of jobbers. A manufacturer of woodworking equipment used in furniture factories, planing mills, agri-

cultural implement plants, and in sawmills sells through his own sales force operating out of several branch offices. The large manufacturers of electrical equipment, measuring and dispensing pumps, textile machinery, and elevators and escalators distribute in the same manner. Time clocks are similarly sold, not because they are highly technical, but because their proper application often involves modification of cost accounting systems to make the best use of the time system. Here, salesmen trained in accounting rather than engineering are used. Office machinery, such as computing machines and tabulating equipment, is sold directly for the same reason, also because of the desirability of combining mechanical service with a sales office. Similar considerations make direct selling of cash registers the almost universal practice.

Machinery Jobbers. A second method of distributing some installations and equipment items is through wholesaler merchants, commonly known in the trade as machinery jobbers or supply houses. If machines are standardized and can be used without special adaptation to a particular factory, they can be sold by jobbers. Industrial tractors and trucks, for example, are standard for all types of factories. One manufacturer of such equipment sells through some forty jobbers who stock the most commonly used trucks, carry certain other models on consignment, and carry repair parts for the principal sizes and models.

Machinery jobbers or wholesalers are located in the larger industrial cities. They represent a number of manufacturers of machinery of a somewhat standardized nature but seldom carry any great amount of machinery in stock and hence can be classified as drop shipment wholesalers. One typical machinery wholesaler in an Ohio city represents 25 different manufacturers of machines used in metal and woodworking plants, including lathes, punches, metal saws, grinders, planing machines, and others. A force of salesmen is maintained by this firm to call on purchasers in eastern Indiana, northern Kentucky, and in about one-half of Ohio.

Secondhand and rebuilt machine tool dealers are located in some of the larger centers. They recondition machinery used in wood- and iron-working plants and resell it to manufacturers in similar lines. Their most distinctive feature is that sales are made almost exclusively through advertisements in such trade papers as the *American Machinist* and *Iron Age,* rather than by use of personal salesmanship.

Manufacturers' Agents. Manufacturers' agents are often used in the distribution of simpler types of plant machinery and equipment not requiring the use of a highly specialized, factory-directed sales force. Like machinery wholesalers, they sell products which are standardized, at least to the extent that they can be used under varying production conditions and hence are of the general purpose type. Manufacturers' agents are more numerous and

are to be found in a greater variety of locations than machinery jobbers, partly because of the lower capital investment required for this type of business. Manufacturers can control sales and distribution policies more closely than when selling through jobbers who deal on their own account. One such manufacturers' agent, with offices in Los Angeles, San Francisco, and Seattle, represents about 40 eastern manufacturers of machinery, used principally in wood- and iron-working plants. He is an efficient and economical distributor with low sales costs because of the large number of companies which his salesmen represent. Companies which sell direct in other sections often use manufacturers' agents in Pacific Coast states because of the expense involved in maintaining direct distribution at such a distance from their factories.

Leasing.[7] Certain equipment items are sometimes installed on the basis of a lease rather than an outright sale. The owner may be compensated on the basis of a flat rental fee per month or per year, or on a royalty basis in relation to the number of units of finished product made with the leased machinery. Under the latter circumstance, counting devices are usually attached to the machines and payment is made on the basis of the number of units which have passed through it. Shoe factories are generally so equipped, and the same arrangement governs the use of some of the machinery in the shoe repair shops.

Equipment used in the construction of roads and large buildings is frequently obtained by direct rental from wholesalers of such equipment. When a contractor secures a large job he often needs a considerable amount of equipment which, if purchased, might not be used again until he secured a similarly large contract, which may not materialize for a long period of time. For this reason, wholesalers of contractors' equipment frequently serve as a sort of clearing house by owning such standard equipment and renting it to contractors for the period of time during which it is needed by the latter. It is then returned to them and again leased to other contractors as needed.

Distribution of Semi-Manufactured Goods. Simplicity characterizes the marketing structure for semi-manufactures. Such products enter directly into the manufacturing process of other companies and are consequently sold on a large scale, whether they come from large factories or small plants. Direct sale to purchaser is the common method. Salesmen call on purchasing agents and sell by personal presentation or by submitting bids or proposals. Long-term contracts involving periodic deliveries and substantial dollar amounts are the general rule.

Clothing manufacturers buy quantities of woolen goods which are finished products of other manufacturers. Manufacturers of machines buy castings,

[7] Leasing as a distribution policy is discussed at greater length in Chapter 31.

sheet or other shaped steel, and crating material, in large amounts. Pharmaceutical manufacturers purchase chemicals by the ton. Often products of this class are made to specifications furnished by the buyer and, in the case of castings, from molds owned or paid for by the buyer. Buyers of semi-manufactured goods have expert knowledge, often reinforcing it by chemical and physical tests. Rational motives rule the buyer. Price, quality, discounts, and delivery dates are the most important factors. Such emotional motives as friendship and imitation are of secondary consideration.

Because of these facts, brand influence is ordinarily of little value. Consequently, many semi-manufactures are not branded. Exceptions occur when the reputation of the producer of the semi-manufactured product may be employed to advantage in facilitating the sale of the finished commodity of which it becomes a component. For example, "Armco" steel products, which are used in making refrigerators, gas ranges, garbage cans, etc., are sufficiently well known that the use of the brand name is often considered an asset to the manufacturer of the finished commodity. The same is true of Fiberglas insulation in refrigerators. Similarly, a number of manufacturers of textile fabrics and plastics advertise extensively to the ultimate consumer in order to make their products more desirable to industrial purchasers who can connect the brand name with their own in the sale of the finished commodity. Illustrative are Monsanto plastics, Enka Rayon, fabrics by Burlington Mills, and Textron.

The sales methods of a large manufacturer of industrial chemicals will serve to illustrate methods of selling semi-manufactured commodities. This company has 9 plants in different industrial sections, sells over 300 different chemicals, and numbers over 80 industries among its markets. Long-term contracts, usually covering a period of six months or more, are common. This enables salesmen to serve many customers, a fact which partly accounts for the practice of the company in making all sales directly to industrial consumers and without the aid of a single middleman. After the chemical has been introduced to the management of a plant and has become a definite part of its productive process, repeat sales follow as a matter of course.

Steel, an important semi-manufactured good, finds its market in a wide variety of industries, most of which buy in quantities sufficient to justify a policy of direct selling by the steel mill operator. Producers of automobiles, tin cans, refrigerators and other home appliances, bridges, machine tool products, all demand a highly standardized product which they can buy in large quantities and which they desire to buy from salesmen with a high degree of technical training. Direct sale by the manufacturer is the most effective method of reaching most such purchasers. One large steel company divides its products into ten groups for each of which there is a separate sales force, since for each there are different buyers and diverse selling conditions are encountered.

In spite of the outstanding predominance of direct-to-user selling, middlemen are employed to some extent in marketing semi-manufactured goods. For example, metal distributors or steel jobbers are to be found in almost all important manufacturing centers. They are specialized wholesalers who perform normal wholesaling functions, selling primarily to smaller manufacturing companies and to larger companies when rapid delivery is essential. Most such firms have facilities for cutting or shaping stock items to customers' specifications. One such jobber normally carries a stock of 10,000 sizes and kinds of steel products such as bars, plates, sheets, tubes, rivets, bolts, nuts, and assorted steel alloys.

Marketing Industrial Parts. A somewhat different marketing problem is involved in marketing such materials as batteries and tires which become a vital part of one product but are the finished product of another manufacturer. Electric motors are supplied to manufacturers of hundreds of electrical appliances by a comparatively few producers of motors. Locks are purchased by manufacturers of filing cabinets from the lock manufacturers. In fact, *assembly* of diverse but completely manufactured parts characterizes much of our manufacturing.

Industrialists must decide in such a case whether it is most advantageous to produce the parts they need or to buy them on the market. Parts manufacturers are specialists and can for this reason often supply better products, and frequently at a lower cost because of the larger scale on which the manufacturing of such parts can be carried on, provided the parts manufacturer makes highly similar or identical items for other customers.

Because many parts have a consumer goods replacement market as well as an industrial parts market, consumer advertising and brand name reputation are important factors. Consumer preferences developed by parts manufacturers in the replacement market are often influential in gaining acceptance in the industrial market, particularly if the part is conspicuous or is an advertisable feature of the original equipment.

Sales of parts are usually made directly to manufacturers using them in their finished products. The Timken Roller Bearing Company, for example, sells practically all of its bearings directly to users. This is done through its highly trained force of sales engineers who are able to make recommendations based upon full knowledge of the problems of antifriction bearings. Even then an order must be approved by the engineering staff of the plant before it can go into production. Obviously, only direct selling would make such service possible.

Small and standardized parts are often sold through industrial distributors. Certain types of valves, fittings, bolts, screws, and other fasteners are often used as parts and are frequently procured from such sources, especially by smaller manufacturers.

Marketing Repair Parts. Manufacturers of industrial machinery and equipment and of many items of consumer durable goods have a somewhat difficult problem growing out of the necessity of making repair parts readily available to users or consumers of the original equipment. In the case of factory items, it is especially important that repair parts be available because an entire production line may be shut down by a breakdown of a part on one machine. When equipment is highly restricted in distribution and parts are of a special-purpose character, there is a prevailing tendency for the distribution of repair parts to follow the same channel of distribution as that used for the original equipment. Thus, the United Shoe Machinery Company, which sells and leases equipment direct to shoe manufacturing companies, maintains its own service organization and stocks of repair parts in each of the principal shoe manufacturing localities. Industrial wholesalers who distribute such products as pneumatic drills also carry parts for them.

When the distribution of the original equipment is very wide and repair service is provided by agencies other than those who sell the original equipment, supplementary channels of distribution are commonly used for repair parts. The greater the degree to which parts are standardized (i.e., can be used interchangeably on equipment made by different manufacturers or on different types of equipment), the greater is the variability in channels. Manufacturers of major appliances and specialized parts manufacturers in this field sell some parts through the channel that handles the orginal equipment, either through appliance wholesalers to retail appliance dealers, or direct to retailer. A large volume of such parts follows another channel. For example, manufacturers of radio and television tubes sell repair market items to a large extent through electronics wholesalers, because such middlemen concentrate to a greater degree upon selling to radio and television repair shops than do regular appliance wholesalers.

The most complex industry with respect to the marketing of repair parts is the automotive industry. This is almost altogether within the field of industrial marketing, since only a small part of automotive repair parts is purchased directly by the ultimate consumer for "self-repair." Special research in this field has revealed that parts manufacturers reach the so-called "after market" by a diverse and complex system of channels.[8] Sales are made by manufacturers as follows: (1) to wholesale parts distributors who in turn sell to smaller jobbers or to various classes of firms performing retail or wholesale repair services; (2) through manufacturers' agents to various classes of customers otherwise enumerated in this listing; (3) to other parts manufacturers, which channel is used by some small parts manufacturers to reach the after market through the sales organization

[8] Charles N. Davisson, *The Marketing of Automotive Parts* (Ann Arbor: The University of Michigan Bureau of Business Research, 1954). See especially pp. 15–24.

of another manufacturer with a broader product line; (4) to automobile manufacturing companies who in turn distribute parts through their dealer organization for original equipment; (5) to fleet operators, especially those who operate large numbers of trucks and buses and who have organized repair facilities; (6) to rebuilders of used automobile engines and other assemblies such as starters or generators; (7) to mail order houses and chain store companies, which is actually in the consumer goods market, since sales are made principally to ultimate consumers for purposes of self-repair; and (8) to oil and tire companies, principally for distribution through their facilities to gasoline service stations that engage in performing minor automotive repair services for the consumer and in installing the items as distinguishable parts like batteries or as accessories as in the case of windshield wipers.

The Distribution of Supplies. Practically all trade channels are used in selling industrial supplies, on account of the great variety of such commodities. Because of their standardized nature, direct selling is less important than in the case of equipment items or raw materials which are purchased in sufficient quantities to make direct sales economical. To a greater extent than for other classes of industrial goods, supplies tend to be purchased locally, and the choice of sources is influenced by considerations of habit and availability.

Wholesalers are common outlets for supplies used in offices of manufacturers, middlemen, banks, professional men, and others. Retailers handle the same products and sell to smaller users. Lubricants are sold as a rule by direct representatives of refiners, but even here wholesalers and even retailers are of some importance, primarily because of their ability to make quick deliveries. Mine supplies are handled by supply houses which specialize in such items. Electrical supplies such as light bulbs are purchased either from a wholesaler of such electrical equipment and supplies or from retailers, depending upon the size of the purchase. Mechanical rubber goods, on the other hand, such as belting, hose, packing, and so on, are sold by supply houses directly to their users.

Marketing Raw Materials. This classification is limited to the basic or "raw" materials of farms, forests, mines, and fishing which have not undergone any change in form through manufacturing and have been processed only to the extent of grading or other activities necessary to facilitate handling and shipping. A large part of the supply of most nonagricultural raw materials is controlled by integrated companies. It is common for steel companies to own or control the mines from which they procure iron ore; many large public utilities, steel companies, and other large users of coal either own or control coal mines; and most large oil refining companies control their source of crude oil. Much of the supply of nonagricultural raw

materials not controlled by integrated companies is marketed through drop shippers, selling agents, and brokers, according to methods described in the preceding discussion of each of these types of middlemen. Because of the special problems encountered in the marketing of agricultural commodities, the following chapter is devoted entirely to that subject.

The prices of many kinds of raw materials fluctuate much more frequently and over a wider range than is the case with other classes of industrial goods. Great risk is, therefore, involved in the ownership of raw material inventories. It is a common practice for processors of raw materials to shift this risk through the process of hedging, which is explained in detail in Chapter 28.

QUESTIONS AND PROBLEMS

1. Briefly define or explain the meaning of the following terms:
   a) industrial marketing
   b) vertical market
   c) horizontal market
   d) reciprocity
   e) industrial distributor
   f) "after market"
2. What are the main classes of industrial goods? Lxplain why this classification is of significance for purposes of marketing.
3. What are the main characteristics of the industrial market that distinguish it from the market for consumer goods? Does each one of these characteristics apply to every item marketed to business users? Explain.
4. Explain why consumer advertising is of special significance in the marketing of but two major classes of industrial goods.
5. What special problems are encountered in the marketing of parts?
6. What is the role of the retailer in the marketing of industrial goods? Explain.
7. How can you account for the predominance of direct manufacturer-to-user channels in industrial marketing in comparison with the almost pervasive utilization of some type of middleman in marketing consumer goods? Does this mean that different principles apply in the field of industrial marketing?
8. In what respects are industrial distributors similar to regular wholesalers of consumer goods? In what respects do they differ?
9. Mention several examples of specific industrial goods that are also sold as consumer goods and which may also be sold as more than one type or class of industrial goods. What are the implications of a multiple market with regard to channels of distribution, advertising, and selling activity?
10. What would be the effect of each of the following circumstances upon the total volume of trade transacted in the industrial market?
    a) Increased specialization in manufacturing
    b) Increased vertical integration by manufacturing companies

11. Why is the discussion of industrial marketing included in a part of the book which deals with wholesaling? Are not many such items sold in quantities of one?

12. Why are industrial goods likely to be more seriously affected by adverse business conditions than consumer goods?

13. If about one-half of all manufactured goods is sold for industrial consumption, why isn't more space in marketing texts devoted to industrial marketing, and why are separate courses in industrial marketing not generally offered by universities? Do you know of any exceptions to this general practice?

14. The Machine Products Corporation has hired you to sell air conditioning installations. Are you likely to call on any wholesalers? Who, in an organization of a prospect, will probably be responsible for buying your product? To which buying motives will you make your appeals?

15. The Ajax Manufacturing Company was producing heavy drilling equipment for sale to industrial users. The entire output was distributed through a selling agent who was able to market these products with a small sales force. The Ajax Company decided to take over the selling end of the business, but was at a loss to know which type of outlets to establish. Outline your suggestions.

16. A salesman for the Hampton Machine Tool Company called upon the purchasing agent of the Kansas City Metal Products Company to attempt the sale of a new model of a metalworking machine priced at $46,000. The purchasing agent was interested in the presentation but stated that he could not take any specific action until he was able to obtain the approval of a plant equipment purchase committee. He also intimated that approval would be unlikely so long as the Hampton Company failed to purchase certain products made by the Kansas City firm. Later in the interview, the purchasing agent mentioned that the Ajax Store Fixture Company ought to be a good prospect for certain items in the Hampton product line. The salesman was surprised because he had thought the Ajax Company specialized in the production of wood store fixtures. Nevertheless, he called at the Ajax office and found that the firm was a potential consumer for several metalworking machines. He was informed, however, that unfavorable conditions in retail trade and a pessimistic outlook by most merchants with respect to store modernization necessitated indefinite postponement of equipment purchases.

    What general characteristics of the industrial market are illustrated in this paragraph?

17. The Quality Electronic Parts Company is a medium-sized manufacturer of electrical supplies and components used by other business firms in the rapidly expanding electronics industry. The firm is well known within the industry and its products are now marketed directly by its own sales organization to original equipment manufacturers, to research and development companies, and to governmental units, principally military. Marketing operations have been confined to the eastern part of the country.

    Company executives have been aware of the rapid development and growing importance of the electronics industry in the Pacific Southwest, and have noted that many of their eastern customers have been expanding

by opening manufacturing establishments in that region. A decision has been made to market company products in that market as soon as arrangements can be made.

The major problem confronting the company is the selection of a new channel of distribution. Competition in the West Coast market is very intense. It consists chiefly of numerous electronics component manufacturers, many of which sell only one line. There is no uniform pattern in the distribution channels employed by the principal competitors; some prefer to cover the market by direct selling while others use distributors most effectively. The picture is further complicated by the fact that the potential market consists of more than 500 small manufacturers.

What channels of distribution should be considered by the company? Which channel do you think should be selected? Why?

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WHOLESALING OF AGRICULTURAL PRODUCTS

Products of agriculture are of basic importance to the consumer, for practically all that we eat, wear, drink, or smoke comes originally from the farm. A large part of our population is engaged in raising, growing, or processing agricultural products; other thousands find employment in the organizations which distribute them to the consumer. Whether measured by their absolute strength, relative importance, or by their peculiar characteristics, institutions engaged in wholesaling farm products are important to the student of marketing.[1]

Distinguishing Characteristics of Agriculture. Farming differs from manufacturing in a number of ways that affect marketing. First, agricultural products generally come from *small producers*. There are more than 5,000,000 farms in the United States, as compared with under 300,000 manufacturing establishments. Since most farmers engage in diversified farming, raising two or more crops or kinds of animals, they are not in a position to make economical carlot shipments to terminal markets. For this reason, farmers usually limit their marketing effort to simple relationships with local market buyers who are chiefly engaged in the activity of

[1] The field of agricultural marketing is of such significance that entire specialized courses are often devoted to it, particularly in colleges of agriculture. For a more detailed treatment see: Richard L. Kohls, *Marketing of Agricultural Products* (New York: The Macmillan Company, 1955); *Marketing: The Yearbook of Agriculture, 1954* (Washington, D. C.: Government Printing Office, 1954); A. D. Larson, *Agricultural Marketing* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1951); and F. L. Thomsen, *Agricultural Marketing* (New York: McGraw-Hill Book Co., Inc., 1951).

assembling the goods into larger quantities for economical handling and shipment.

Second, the *quality of farm products cannot be determined in advance.* Being subject to the vagaries of climate, pests, and crop diseases, the quality of produce is often determined more by nature than by the grower's effort. Furthermore, there are likely to be marked variations in quality within the crop yield of a particular farm. This accounts for the great importance of the function of grading.

Third, the same conditions that explain quality variances also bring about a *lack of control over the quantity produced.* While the farmer has the power to determine the acreage to be planted, he is uncertain about the crop yield. Favorable or unfavorable crop conditions are likely to affect most farmers in a particular region rather uniformly, with the result that there are irregularly recurring market gluts or scarcities.

Fourth, because of the large number of small farmers, individual producers *cannot engage in demand-creation activities.* The character of demand is thus a noncontrollable factor for the producer. As a result, advertising and personal selling play an insignificant role. The only important exceptions are consumer farm products sold through large cooperative marketing organizations.

A fifth rather distinctive characteristic is the *seasonal character of production.* Most crops are harvested at a particular time, and for many farmers the total harvest output becomes available within a few days. The function of storage becomes unusually strategic, because annual crops must be carried from times of excessive abundance to periods of continuing need.

Sixth, most agricultural *commodities are quite bulky and heavy* in comparison with their value at the farm, and many are perishable or present unusual handling problems, as is the case with sugar beets and livestock, respectively. Transportation services are very significant factors in marketing, and transportation costs are a substantial component of value at the point of final use.

A seventh characteristic is that *many producers cannot withhold any considerable part of their produce from the market.* Financial needs are commonly more pressing than in the average factory. For this reason crops are sent to the market as soon as possible. Lack of adequate storage space contributes to the same result. Many crops, especially fruit and milk, can be held only under refrigeration. Livestock does not fatten in proportion to the food consumed after a certain stage is reached and hence must be sent to market when ready. These and other factors make it difficult for the average farmer to sell at times when prices may seem most advantageous.

Trend to Mitigate Effects of Distinguishing Characteristics. The foregoing characteristics are traditional in the sense that they have prevailed

as long as it has been possible to draw distinctions between agriculture and manufacturing. Secular or long-run developments have, however, tended to reduce rather than accentuate the differences. Agricultural research has resulted in improved plant and livestock characteristics, involving the development of new types and applications of fertilizers, use of better insecticides, control of many plant and animal diseases, and soil management programs. Such progress has made the quantity and quality of production somewhat more predictable for the typical farmer. There is, furthermore, a greater tendency to operate farms more like other regular business units, less as self-sufficient economic entities. Whereas the typical farmer of the 1920's raised or grew 70 to 80 per cent of his own production items such as seed, animals for power, or feed, the farmer of the 1950's bought from business about 50 per cent of the production input items in the form of machinery, tractor fuel, commercial fertilizer, mixed feeds and supplements, and even building materials.[2]

Certain agricultural marketing problems growing out of wide and often depressing price fluctuations and the weak bargaining position of the farmer have been modified to some extent by the development of agricultural marketing cooperatives and by government control of production and support of prices. While governmental measures are discussed in a later part of this book, it may be noted briefly that these have been handled largely through the Commodity Credit Corporation (CCC), a federally financed agency established in 1933. Prices have been supported at varying levels of "parity," a pricing formula conceived to provide the farmer with purchasing power equivalent to that which he had in a designated base period.

Two main instrumentalities of support have been utilized, involving nonrecourse loans and direct market purchases. Under the first method, the farmer has the opportunity to store his commodities, obtain a CCC loan on them at the current price support level, repay the loan at a later date if the market price moves above the support price, or surrender the commodity to the CCC if the market price is at or below the support level. This method has been used for a number of important storable commodities including grains, tobacco, and cotton. Direct market purchases have been utilized for perishables such as eggs, turkeys, butter, and beef. When market prices move below the official support level, the CCC buys such items from handlers or processors, thus supporting the market. Commodities coming into possession of the CCC are resold through normal channels of trade only when current market prices are above support levels; otherwise, commodities can be moved only through "noncompeting" methods (e.g.,

[2] John H. Davis, "From Agriculture to Agribusiness," *Harvard Business Review,* January–February, 1956, p. 107.

school lunch programs, poor relief, foreign aid), must be held in storage, or may have to be destroyed.

Production has also been controlled by restricting eligibility for CCC loans to farmers who participate in production or marketing quota programs and, beginning in 1956, by a "soil bank" program in which cooperating farmers receive payments for withholding certain acreage from current use but maintaining it in a prescribed manner that would presumably conserve land resources. It is apparent, therefore, that the federal government plays an unusually prominent role in the field of agricultural marketing.

In spite of certain modifications of the historically peculiar characteristics of agriculture, the fact remains that agriculture has many unique features which give rise to unusual marketing methods and problems.

Classes of Farm Products. It is traditional to divide agricultural products into two main classes. First, farm products ready for consumption without basic processing account for about one-fifth of the value of all agricultural commodities marketed. For this class, processing is limited to incidental activities such as grading, packaging, trimming, or treatment for sanitation, purity, or preservation. Examples are fruits and vegetables, milk, and nuts. The second class consists of products that undergo basic processing which changes them into another form with greater utility. Most of our output of livestock, poultry, grains, cotton, and tobacco fall into this category. Such products are commonly known as industrial raw materials.

While this classification is meaningful for some purposes, it has limitations in that many commodities fall into both classes. Milk, for example, may be sold in the fluid state or transformed into butter, cheese, or powdered milk. Fruits and vegetables may be sold unprocessed or may be canned, bottled, frozen, or transformed into essentially different commodities such as tomato catsup or vegetable soup. Furthermore, some of the same marketing methods and institutions may be involved in the marketing of both classes of goods.

Structure of Markets

Agricultural marketing is characterized by the movement of commodities through a series of different markets in which supplies are increasingly concentrated and then dispersed. Most commodities move from large numbers of small farms to a smaller number of local market agencies, then to regional or central markets, and, finally, in the case of consumer goods, to wholesale dispersion markets. Obviously, a large and growing part of total farm marketings stops at some stage of this movement, where it is purchased by manufacturers for industrial use.

Local Assembly Markets. Local growers' or assembly markets are within the areas of production, usually in county seat towns or in other rural

marketing points. The major functions performed here are assembling the produce of individual farmers into economical lots, grading, packaging or crating, and shipping. Within these markets, the farmer has the opportunity to dispose of his produce to one of several kinds of buyers. While the types of buying agencies vary from one market to another, the most common classes include: (1) local processing enterprises such as fruit canners, small meat packers, and dairy processing plants; (2) merchant buyers or assembling wholesalers, some of whom operate regular business establishments, whereas others move from one local market to another as crops mature; (3) resident or traveling salaried buying employees of chain store organizations or nonlocal food processors; (4) shipping point auction companies; (5) agents or brokers who buy on a commission basis for several principals; and (6) farmer-owned cooperative marketing associations.

Regional or District Markets. These markets often constitute an intermediate step of concentration between local assembly points and central terminal markets. They are characterized by a concentration of supply drawn from farms located over a considerable geographic area, consisting sometimes of several counties and in other instances of all or parts of several states. The major buyers in such markets are food processing establishments that operate most economically upon a considerable scale, thus precluding widespread plant locations in numerous local assembly markets. Common processors of this type are meat packing concerns, large food canners, egg-drying plants, and frozen food processing establishments. They buy to some extent direct from farmers, located in the vicinity of the market and from middlemen who operate in surrounding local assembly markets. Regional markets also are significant in the wholesaling of consumer farm produce. As is explained later, regional markets have grown in relative importance, in part by taking over some of the activities usually performed in local assembly markets and in part by usurping traditional functions of central or terminal markets.

Central or Terminal Markets. Almost all principal farm commodities have a limited number of important central or terminal markets. Such markets represent the final stage in the *concentration* of the supply of the commodity and often the first stage in its dispersion to industrial users or to ultimate consumers. Buyers and sellers representing amassed forces of demand and supply are to be found in such markets. Their activities are important factors in the establishment of the value of commodities through competitive price-making forces. Prices established in central market trading often set the value for commodities not only for the central market area but also for regional or local assembly markets. Prices are commonly adjusted to central market quotations by reference to transpor-

tation charges, handling expenses, and buying or selling commissions necessary to accomplish the process of exchange and the movement of physical supply from one type of market to another.

Terminal markets for consumer farm produce tend to be more numerous than those for industrial raw materials. They are located in the largest consuming centers in order to expedite quick dispersal of commodities. On the eastern seaboard, for example, Boston, New York, Philadelphia, and Baltimore are common examples of terminal markets for consumer farm produce.

Terminal markets for specific types of agricultural raw materials tend to be more limited in number and are usually located in communities that are well known as processing or exporting centers. A few examples of important terminal markets are Chicago for all classes of livestock and grains; Kansas City for wheat and feeder-cattle; South St. Paul, Minnesota, and Sioux City, Iowa, for hogs; Denver and Omaha for sheep and lambs; Minneapolis for various grains; Boston for wool; and New York, New Orleans, Memphis, Dallas, and Houston for cotton.

Organized commodity exchanges are among the principal institutions usually found in terminal markets. Exchanges are membership organizations consisting of individual buyers and sellers, including representatives of merchant and functional middlemen and of manufacturers or processors. They usually provide a market place in which members meet at prescribed hours to transact business under standard rules of trading which are laid down by the group. Facilities are provided for collecting and disseminating market information and for settling any trade disputes. Some of the larger exchanges provide facilities for futures trading in commodities, which is explained and illustrated in Chapters 27 and 28.

Unusually large concentrations of wholesaling institutions and facilitating agencies are to be found in most terminal markets, with some variations to be expected in accordance with types of prevailing commodities. The most important classes include wholesale merchants, many of whom operate substantial physical facilities such as grain elevators and warehouses; numerous offices of commission firms and brokers; auction companies for fruits and vegetables; offices and other facilities operated by cooperative marketing associations; terminal transportation facilities, including rail, motor truck, and often water; storage and handling agencies such as terminal public grain elevators, merchandise and cold storage warehouses, and stockyard companies; banks and other financial institutions that specialize or do a large volume of financing in commodities traded in the market; publishers of special commodity trade papers and journals that carry local and general market news; and major processing plants, especially in principal terminals for livestock and grain.

Wholesale Dispersion Markets. Fresh fruits and vegetables consumed within terminal market cities are dispersed to retailing and institutional organizations through terminal market wholesale agencies. There is, however, a substantial flow of produce to other wholesalers located in secondary or dispersion markets in surrounding areas. In Columbus, Ohio, for example, local produce jobbers and chain store warehouses purchase a large part of their supplies at the fruit auction located in Cincinnati, a major terminal market for a substantial region in Kentucky, Ohio, and Indiana. Terminal market purchases by dispersion market wholesalers are limited chiefly to items that are produced in distant regions. Such merchants also buy from, or sell on a commission basis for, local producers of consumer farm products.

Middlemen play a limited but significant role in *dispersion* markets for raw materials, especially wool and cotton. Such merchants assemble numerous grades of a given quantity, supplying these as needed to small manufacturing firms and even to large processors, especially when the latter have only occasional needs for particular grades.

Bypassing Local and Terminal Markets. The traditional agricultural marketing structure, involving local growers' assembly markets and terminal concentration markets, was developed in the period between the Civil War and World War I. It grew out of, and at the same time contributed to, the expansion of our rail transportation system. The structure of markets that resulted is explained by the economies of long-haul, bulk movement of basic commodities from highly specialized regions of agricultural production to distant large population centers which were both the major centers of processing and the most important consuming markets. Since then a number of factors have modified the flow of farm commodities so that an increasing proportion of the total supply moves direct from farms to processing plants and to wholesalers and chain store buyers located in regional markets. Obviously, this does not apply to futures markets on organized commodity exchanges.

One important cause for the change is to be found in improved highways and the growing importance of motor truck transportation. Whereas farmers were at one time almost completely dependent upon rail transportation for movements over any distance, the motor truck now provides a flexible, economical, and commonly used vehicle for assembling products on the farm and moving them, without secondary handling, to processors and other buyers in regional markets. The number of "assemblers" enumerated in the Census of Business declined from 34,226 in 1929 to 13,255 in 1954, and this is attributed in large measure to developments in motor truck transportation.

A second factor is population decentralization. Large older cities in the northeastern one-fourth of the country do not account for nearly the pro-

portion of the total consuming market they did in the earlier era. At the same time, population growth in newer large and medium-sized cities throughout the southern, midwestern, southwestern, and far western sectors have contributed to the need for the development of regional marketing facilities in these areas.

Substantial decentralization of processing industries constitutes a third explanation. For example, a major part of the total capacity of the meat packing industry was at one time located in Chicago and in a limited number of other major livestock terminal markets, presumably because of the concentration of raw materials, nearness to large consuming markets, economies of large-scale processing operation, and accessibility to rail transportation facilities for distribution of processed goods to other market centers. Since the early 1920's growth of the meat packing industry has taken place chiefly in communities located in the midst of livestock producing regions, principally because of the development of new centers of livestock production as in Florida, shorter hauls for live animals and processed items, growth of new consuming markets, and lower wage rates in smaller cities. Similar decentralization has taken place in the textile industries, with the movement of manufacturing establishments away from the New England area. This has tended to reduce the importance of Boston and New York as concentration markets for a large physical supply of textile raw materials.

Fourth, the increased importance of chain and supermarket organizations in the food field has contributed to the bypassing of terminal markets. This has reduced the role of the dispersion market jobber who draws most of his supplies from terminal markets for farm produce. Even though chain store organizations utilize terminal markets to a considerable extent, many of them purchase on such a large scale that they can maintain their own buying staff in growing regions and arrange for direct truck movements from farms to chain store warehouses.

Improvements in standards and grading methods and an accelerated flow of a larger quantity of useful market information constitute an additional factor. Farmers and local market middlemen were formerly dependent upon terminal market quotations and had a natural inclination to arrange for sale in such markets in order to be sure of a sale at the highest price justified by demand and supply conditions. Through widespread publication of price quotations and demand and supply conditions in local newspapers and by radio and television broadcasts, sellers are more aware of opportunities in a variety of markets and are more inclined to arrange for marketing in nearby regional centers.

While additional factors have been advanced by agricultural marketing specialists to explain the bypassing of local and terminal markets,[3] the

[3] See, for example, *Marketing: The Yearbook of Agriculture, 1954, op. cit.*, pp. 36–48.

foregoing are believed to constitute the major explanations. They may be formulated in terms of a principle, as follows: *To the extent that increases are experienced in the use of motor truck transportation, in the degree of decentralization of population and processing industries, in the concentration of food distribution in large organizations, and in the prompt availability of reliable market information, the less important do local assembly and terminal markets for agricultural commodities tend to become.* The actual extent to which terminal markets have been bypassed, as compared with earlier decades, has not been accurately determined. All qualified and impartial observers agree, however, that the trend has been of great quantitative significance and that it will continue in the same direction over a long course of years.

Marketing Methods and Agencies

As agricultural commodities flow through the market structure briefly described in the preceding section, a wide variety of distribution channels and types of middlemen is utilized. In many respects, these present a distinct contrast to the marketing of manufactured goods, although certain similarities may also be observed, as noted in the following discussion.

Direct Sale to Processors. Direct sale from farmers to manufacturers or processors is limited chiefly to highly perishable commodities and to circumstances in which processing establishments are conveniently accessible to farmers. Its role has been growing, however, with the greater use of motor truck transportation and the decentralization of processing industries.

Direct-to-processor marketing is affected to a considerable extent by the degree to which a given area tends to assume specialized production characteristics. Farmers producing cream in Wisconsin or Minnesota, leading dairy product states, are likely to sell direct to local creameries. In Kansas or Nebraska, where there is less emphasis on dairy farming, processing plants are less numerous and more widely scattered. Farmers in these states are more likely to sell to a local assembler who ships cream to processing plants located at some distance.

In the early years of the poultry industry, it was common to sell live birds to local market wholesale poultry dealers who, in turn, would arrange for shipment to poultry processing firms in major central markets. A specialized commercial broiler industry has developed on a large scale since the mid-1930's, with the most significant concentrations of production in the Delaware-Maryland-Virginia peninsula and northwest Georgia. In these and other important poultry regions, it is common for processors to finance poultry raisers by supplying them with hatchery stock and feed. When the poultry is ready for the market, processors buy the birds from

raisers, process them, and then ship dressed birds by fast motor truck to major eastern market centers. It has been estimated that about 90 per cent of farm poultry production in the Del-Mar-Va peninsula and about 66 per cent of the Georgia production is marketed direct to processors located in the poultry producing area.[4]

In the marketing of highly perishable commodities with a short processing season, growers and processors are mutually interdependent to an unusual degree. Farmers who grow crops that must be marketed quickly like to be assured of at least one market outlet before planting. Similarly, processors who market a given quality of product under an established brand name desire assurance of sources of supply for particular quantities of specific varieties of produce. This has given rise to the common practice of contract negotiations between growers and processors in advance of production, especially in the fruit and vegetable canning and beet sugar industries. Such contracts customarily provide for the farmer to supply the processor with the output of a given number of acres. Prices are sometimes stipulated, or the contract may provide for a specific formula according to which prices are to be calculated at time of delivery. In some cases where the processor has strict quality requirements, he may furnish seed or plants, arrange for periodic crop spraying and dusting, and may actually undertake to harvest the crop at maturity.

Assembling Wholesalers. Assembling wholesalers differ from regular wholesalers of consumer goods and from industrial distributors in an important respect. Instead of buying in large quantities, breaking bulk, and selling and delivering to customers in smaller quantities, as is customary in wholesaling manufactured goods, assembling wholesalers buy from numerous small farms, assemble the goods into economical shipment quantities, and sell them in larger quantities than those purchased. The assembling wholesaler has no sales force in the usual sense because he always has a regional or central market outlet for his produce at a publicized competitive market price. His main task is that of observing prices in central markets and buying from local sources at a lower level of prices that provides a margin adequate to cover expenses of operation and allows a reasonable net profit.

Assembly is not the only service of these merchants, for grading is also essential. Cream station operators use the Babcock test to determine butterfat content. Buyers of apples and citrus fruit usually operate packing houses, and assemblers of grain operate elevators with equipment for both grading and storing. They are thereby able to ship commodities of a definite size and grade and thus can fill exact demands. Assemblers perform the finance function, for they pay cash and do not receive their returns until sales

[4] Richard L. Kohls, *op. cit.*, p. 267.

are made, often weeks later in the case of certain fruits. They assume risk when they buy on current quotations and sell at a future time. Because of their specialized knowledge and situation, they collect and interpret market news.

Smaller assembling wholesalers often combine some other form of business operation with that of the assembler. For example, in small communities it is common to find grain assemblers selling farm feeds and fertilizer. This provides an opportunity to utilize physical facilities and personnel more efficiently and tends to even out somewhat the seasonal character of the business.

Independent Trucker-Buyers. Independent trucker-buyers who do not operate a regular place of business are an important factor in many regions that produce perishable farm produce. Their method of operation is that of buying from farmers, or sometimes from independent cash buyers, and selling in a distant market. Peaches are hauled from Michigan to Iowa and Minnesota, watermelons from Georgia to Ohio, and citrus fruit from California to Washington where a return load of apples or pears is secured. Advantages are speed of transportation, loading at the farm or orchard, and delivery directly to the chain store or other large receiver. Moreover, because of his great mobility the trucker-buyer can quickly operate in regions of temporary oversupply or where other cash buyers are not present in sufficient numbers to furnish a good market. All of this is definite gain to producers.

Trucker-buyers have been criticized, however, because of an alleged tendency to disrupt balanced markets. On the basis of rail shipment data for commodities, released by the U. S. Department of Agriculture, most shippers can divert their products to markets where there is the greatest need for them. It is claimed that many truckers do not function on the basis of such market information and as a result often deliver many loads to markets in which an oversupply is created. Experience has taught that just about every element in a market loses when prices are demoralized by an improper balance between supply and demand.

Commission Merchants. The operations of commission merchants in the field of agricultural marketing are somewhat similar to those explained in connection with the wholesaling of manufactured goods. Variations in method are encountered in the marketing of specific classes of commodities.

Fresh Farm Produce. A commission firm dealing in consumer fresh farm produce receives the product; handles, conditions, and otherwise prepares it for market; sells in his own name, without divulging the name of his principal, for the best price available; collects and remits the proceeds to the shipper after deducting his commission, transportation charges,

and any expenses incurred for cartage, storage, and repacking. In making remittance, he renders an "account sales," consisting of a statement showing what disposition has been made of the consignment, even before collections have been made from the buyers. An account sales is often rendered within 24 hours after consummation of the sale. Except when restricted by specific instructions from the owner, the commission merchant has full control of the selling and can exercise his best judgment and ability. He either sells in car lots on the railroad track or else breaks bulk, carts the goods to his place of business, and makes sales and deliveries in small lots. He is entrusted with the management, control, and disposition of the goods he handles and has a special property in them, including a lien for his interest and his commission.

Commission dealing in consumer farm produce was widely practiced in a former era when marketing methods were crude, goods unstandardized, transportation facilities inadequate, slow, and uncertain, and knowledge of market conditions was insufficient. Under such circumstances, few merchants were willing to assume risks involved in outright purchase of agricultural products at point of origin. Prices offered were therefore too low to induce producers and local middlemen to sell outright. So long as these conditions prevailed, the commission business flourished.

Two major long-range developments have resulted in a gradual decline in commission dealing in favor of an increasing outright sale by local shippers to regional or central market purchasers. First, the use of commonly accepted standards and grading systems, coupled with improvements in speed and special handling facilities in transportation, have made it possible for merchant buyers to be more confident of the quality and condition of goods when received at regional or central markets. Second, improvements in communication and the dissemination of market information have reduced risks by making it possible for shippers and wholesalers to avoid market gluts with their disastrous consequences.

In certain cases, the commission method also became unpopular with shippers. Some firms abused their trusted status by buying consigned produce *for their own account* at lower than market prices, thus reaping a benefit at the shipper's expense. Opportunities for such abuses were most prevalent when a considerable distance separated commission merchant and shipper and when marketing information was very limited and disseminated slowly. Thus, long-run developments have contributed to the shipper's desire to make outright sales, as well as to the commission merchant's willingness to buy for his own account.

Whereas formerly commission men seldom bought any produce outright, many such houses now handle on a consignment basis no more than 20 per cent of the goods they sell, the remaining 80 per cent being bought

on their own account, except in the large cities where commission dealing is more prominent. In such cases the middleman has truly become a merchant, so that the designation *merchant* is more descriptive of his function than the older term commission *man* or commission *house*. Even the newer term presents a distorted picture of the actual situation. Here we have a case where methods of doing business have changed without a corresponding change in the name of the firms, either because of the desire to emphasize their readiness to serve clients in the sale of consignments or because of good will that may be attached to the old name, or on account of mere neglect to effect a change that is not regarded as vital.

Livestock and Grain. Commission dealing is extremely important in the marketing of livestock and grain at major terminal markets. Terminal markets for livestock are at some considerable distance from the typical farmer and not conveniently accessible to him. Thus, he finds it expedient to sell livestock through an intermediary, usually a livestock commission firm, which may be an independently owned business or owned by a livestock cooperative marketing association. A livestock shipment is consigned to a commission firm which takes custody of the animals upon arrival at the facilities of a stockyards company. The stockyards firm does not engage in buying or selling, but merely provides physical facilities for the care and handling of animals for a rental fee. Salesmen for commission firms and terminal buyers are expert judges of quality and are well informed about supply and demand conditions generally and for specific grades of individual species. Sales are effected after buyers' inspection of individual offerings and are consummated through a process of bargaining and haggling. The commission firm receives a fee for its services and renders a prompt accounting of the transaction to its principals.

Commission dealing in grain differs in several respects. Most grain that moves to terminal markets is assembled in local growers' markets. Thus the central market commission firm usually represents a local assembling elevator rather than a farmer. Grain shipped from country points is consigned to a commission firm which takes custody of rail car shipments upon arrival at the terminal market. It makes immediate arrangements for grading according to government standards. Samples are taken from arriving cars and the grain is sold on the basis of such samples on the floor of an organized commodity exchange.

The continuing significance of commission dealing in livestock and grain is explained by several factors. First, there is little opportunity for the abuses that have been associated with this method historically in the marketing of fresh farm produce. This is explained by the public character of transactions in terminal markets and by widely and rapidly disseminated price quotations for specific grades of livestock and grain. Second, there

is always a ready market for these commodities at the prevailing market price for a given grade. The shipper, therefore, has little fear that the commodities will not be sold upon arrival. Third, most commission firms are members of an organized exchange or other group and sell according to rules and standards of ethical conduct which prevent, among other things, abuses and unfair dealings with shipper principals. While the commission firm's relationship with its principal is confined to responsibility for the sale of a particular consignment, most shippers make frequent or periodic use of some one commission firm that has rendered satisfactory service in the past.

Brokers. A broker may act as an agent for agricultural producers and country shippers or as a representative of central market wholesale middlemen who wish to buy car lots of produce from shippers at assembly points. At times they act within the city wholesale trade, helping one wholesaler sell to or buy from another such middleman. Sometimes the broker makes no direct sale but confines his activities to effecting arrangements for sales through an auction company.

Since brokers do not usually have physical custody of shipments, their operations are largely confined to commodities that are sufficiently standardized to permit the negotiation of exchange on the basis of description. Sale through brokers is especially important when a shipper wishes to "try the market" by getting offers from one or more buyers prior to consigning goods to a particular destination. This may be illustrated with reference to northwestern apples. When a carload is available for shipment, the seller, who may be a large grower, a cooperative association, or a local middleman, writes or telegraphs a description of the offering to one or more brokers. The broker then canvasses the trade diligently and gets in touch with dealers who are likely to buy the goods and sends the vendor the best bid obtainable. When buyer and seller have agreed on a price the broker notifies the shipper to forward the car f.o.b. usual terms, and to send a draft attached to the bill of lading on the broker's bank. Permission is usually given to inspect the merchandise prior to acceptance, unless official inspection services are available at the shipping point, and the goods are sold f.o.b. cash track, in which case payment is due immediately and all risks thereafter are assumed by the buyer. On accepting the car, the buyer orders his bank to pay the draft and proceeds are remitted to the shipper. If the car is not accepted and complications develop, the broker may be given authority to settle the dispute and make proper allowances.

When a broker represents a buyer, he gets in touch with sources of supply and secures offers which are then transmitted to his principal or client for acceptance or rejection. If contract terms and conditions are satisfactory, the broker notifies the vendor and his part is completed.

Auctions. The auction method of sale is encountered only occasionally in the marketing of manufactured goods but is of great significance in agricultural marketing. Auction companies provide the facilities and mechanism *for public exchange.* Facilities are usually available to all sellers who wish to offer commodities and to all buyers (except in tobacco auctions where buyers must be licensed for tax-collecting reasons) who wish to bid on them. Sales are usually well publicized in advance or are held at specific times well known in the trade. Exchange is effected in accordance with definite rules, with sales made to the highest bidder. For its services, the auction company receives a fee which is usually charged as a small per cent of the value of the commodities sold. Auctions are of chief significance in the marketing of certain fruits and vegetables in terminal markets and in marketing tobacco and livestock in producing regions. They are also used for selling furs in terminal markets, and live poultry and certain fruits and vegetables in growing areas.

Terminal Fruit Auctions. Fruit auctions located in 13 terminal market cities[5] handle a large proportion of the annual supply of fresh deciduous and citrus fruits. They also sell some potatoes, bananas, and certain vegetables.

Cooperative shipping associations supply about two-thirds of the volume of commodities sold through such auctions and the remainder is accounted for by assembling wholesalers and certain large individual producers. The principal buyers participating in the auctions are representatives of chain store companies, central market wholesalers, and produce jobbers located in dispersion markets in the surrounding area. Small buyers often purchase through buying brokers who represent them at the auction.

Upon the arrival of cars at the auction, goods are unloaded and placed in storage, usually adjacent to the auction room. Next is the separation of goods into lines or lots consisting of packages of the same brand, size, and grade from a single car. Samples are then selected at random by representatives of the auction company and made available for inspection by prospective buyers. Sales are made on a strictly "as is" basis, but on the assumption that samples have been fairly taken.

A catalog showing all lots to be offered and essentials of grade and size is prepared and used by the auctioneer and the buyers. Clerks record the transactions as they occur, and the buyers arrange for removing their purchases. Usually credit is granted for 10 or 15 days, although some sales are for cash only.

[5] They are, New York, Philadelphia, Baltimore, Boston, Pittsburgh, Cleveland, Cincinnati, St. Louis, New Orleans, Chicago, Detroit, and, for deciduous fruits only, St. Paul and Minneapolis. Sunkist Growers, Inc., conducts an auction at Los Angeles for the sale of "culls," i.e., fruit not high enough in quality to justify shipment to an eastern market.

Tobacco. The auction method of sale has been found well suited to the sale of tobacco largely because of difficulties in grading. Small differences in quality are often responsible for rather substantial differences in value. Buyers and sellers therefore prefer a system of exchange based on visual inspection of lots offered for sale and competitive bidding.

More than 90 per cent of the tobacco crop is sold through some 171 "loose-leaf" auctions which are conducted in large tobacco warehouses located throughout the Southern tobacco growing states.[6] Before offering tobacco for sale, the farmer sorts it into different lots according to color and other factors relating to quality. Each lot is placed in a separate basket, weighed, and graded by a federal inspector. Bidders at the auction are representatives of tobacco manufacturing companies and smaller speculative buyers. Sales are made with great rapidity, usually at the rate of 350 to 400 baskets per hour. Farmers receive payment within a few minutes after close of the auction.

Livestock. Marketing of livestock through local or *shipping point auctions* has increased considerably since the 1930's. It provides the farmer who does not wish to ship to terminal markets with the opportunity to sell locally on the basis of competitive bids. Auctions constitute the principal method of selling hogs from the farm but are also used for other important forms of livestock. Throughout the United States there are about 2,300 livestock auctions,[7] located principally in rural marketing centers, and concentrated heavily in southern and southeastern states which are most remote from terminal market facilities. Sales are made to meat packing companies, other farmers who buy animals for feeding or breeding purposes, and, to a limited extent, to speculative buyers. Auction company personnel receives livestock consigned for sale and cares for animals after sale until shipment is made. Animals are sold in a sales ring to the highest bidder. In small markets, it is common to restrict the operation of the auction to one day per week in order to concentrate supply and demand factors.

Advantages of Auction Sales. Probably the most significant advantage claimed for the auction method of sale is the free play of supply and demand thus made possible. It brings the buying power of the market together and stimulates active and unrestricted bidding. Consequently, it exerts a stabilizing influence on the market to the benefit of both buyer and seller, the latter presumably securing as high a price as market conditions warrant. Auctions also afford a market for goods which must be sold quickly because they are perishable or which enjoy no established market, although best results are not secured on ungraded or defective merchandise. It is

[6] *Marketing: The Yearbook of Agriculture, 1954, op. cit.,* p. 440.

[7] *Pork Marketing Margins and Costs* (Washington, D. C.: U. S. Department of Agriculture, Miscellaneous Publication No. 711, 1956), p. 28.

further claimed that auctions are a cheap method of selling, but such a claim must be discounted, especially in the case of fruit auctions, because an additional middleman known as the auction receiver or some city representative of the shipping organization is often involved. In addition, buying brokers are of necessity called into existence to serve the needs of the smaller buyers or out-of-town clients.

Publicity incident to auction sales renders the vendor some assurance of fair dealing. Prices are made public immediately after sale by means of trade publications, newspapers, and through price-realized catalogs. This publicity affords another advantage in that auction-established prices on certain products serve for guidance in later private transactions.

Disadvantages of the Auction Method. Because full play is given to the forces of supply and demand, very wide price fluctuations frequently occur. If the supply is small and the demand brisk, prices soar, but drop precipitously when the reverse is true. Such variations may be greater than justified by the entire market situation. A second disadvantage is that it is time-consuming. At private sales, buyers can visit several wholesale suppliers, compare prices and quality, and make decisions in a short time. If they buy on the auction they may be forced to wait some time—often some hours—until the merchandise in which they are interested is offered. Partly for this reason, many smaller purchasers employ buying brokers.

Objection has also been raised to certain practices which tend to distort actual supply and demand conditions. Sales may be influenced by "puffers," "by-bidders," or "cappers." These are fictitious bidders who have no idea of making actual purchases but are employed by sellers to boost the price. This practice is forbidden by all auction companies and is believed to be practically absent on the terminal fruit auctions. Similar in effect and also against the rules is the practice of some receivers to bid on their own goods in order to raise the price. This is not normally necessary as the seller has a right to set a minimum before the sale starts and, usually, to withdraw his offerings before they are actually sold. A final objection is that the auction method is unfair to some vendors. Those whose goods are sold early in the day sometimes receive more than do consignors whose offerings are sold some hours later.

Wholesalers in Concentration and Dispersion Markets. Some large wholesalers act as *primary receivers* for consumer farm produce arriving in central markets. They buy in large quantities from shippers in local assembly markets and resell, also in substantial quantities, to large-scale retailers and to the jobbing trade in their own city and in nearby communities. Some of them do not carry a general line of produce but specialize in specific commodities and enjoy a reputation in the jobbing trade as an assured source of supply for potatoes, tomatoes, or some other item.

Other wholesalers, often known as produce jobbers, are to be found in practically all cities where there is a significant number of retail grocery stores. Their principal service is in facilitating the rapid dispersion of perishable goods to the vast number of small retailers who do not find it economical or convenient to purchase from central market middlemen. Produce jobbers purchase from central market wholesalers, auctions, and brokers, and also buy direct from agricultural producers, especially those located in the nearby area. In most cities such jobbers are clustered together in what is known as the wholesale produce district. They perform most of the usual services of regular wholesalers of manufactured food products, including credit and delivery. There is, however, less emphasis upon selling because retailers commonly visit the produce market in the early hours of the morning and make personal selections, or place orders by telephone.

The importance of the produce jobber has diminished somewhat. During the 1920's and 1930's, the growth of chain food organizations that distribute produce through their own warehousing facilities made inroads into the produce jobbers' potential market. More recently, there has been a tendency for general-line grocery wholesalers to add fresh produce departments, along with other classifications, to fortify their position as complete suppliers to the retail grocery trade. In a 1956 survey believed representative of larger and more progressive full-line grocery wholesalers, it was reported that 26 per cent of them operated a fresh produce department. In the case of retailer-owned cooperative wholesalers and voluntary group wholesalers, the proportions were higher, being 35 per cent and 29 per cent, respectively.[8]

Cooperative Marketing of Agricultural Products

Marketing of members' products through agricultural cooperative associations is of such great significance in the field of agriculture that it merits special attention. In the following paragraphs, consideration is given to the policies and procedures used by such associations and to the conditions under which agricultural producers can engage most successfully in cooperative marketing activity.

Nature and Objectives. Cooperation by producers or sellers differs from consumer cooperation in that it involves the substitution of collective for individual action *for the purpose of enhancing the profit position of the producers.* In the field of agriculture, in which it is by far the most important, cooperation has taken the form of organized agencies engaged in assembling, grading, processing, and selling the product of the individual

[8] Robert W. Mueller, in a published address delivered to the annual convention of the National-American Wholesale Grocers' Association, Chicago, Ill., March 7, 1956, p. 18.

farmers belonging to the association. Such organizations, in some cases, replace private processors or buyers who have been handling the produce and, in others, supply such facilities to communities which lack adequate individually owned marketing enterprises. For example, tobacco cooperatives have attempted (unsuccessfully) to replace individual sales at auction, but western apple shipping associations were first formed because efficient private buyers and shippers were largely absent. Numerous cooperative creameries in Iowa and Minnesota were organized because private initiative had not entered the field. Many farmers' elevator associations have been formed as a protest against domination of local markets by "line" elevators, which are local units operated by large multi-unit elevator companies.

Certain objectives have prompted farmers to form cooperative associations. The most common among them may be summarized as follows: (1) to substitute planned and orderly marketing for unorganized or chaotic dumping of products on the market; (2) to stimulate better merchandising practices, as illustrated by careful grading and advertising campaigns for certain consumer farm produce; (3) to increase the bargaining power of the farmer by pooling the offerings of small individual producers; (4) to eliminate alleged trade abuses, as, for example, excessive charges sometimes made by cotton gins or livestock companies, especially when such agencies have enjoyed a monopolistic position in local markets; (5) to reduce marketing costs with expectations of higher prices for farmers; and (6) to improve production methods by stimulating better livestock breeding, crop spraying or dusting, and harvesting methods.

Historical Development and Present Status. Dating from about 1865, cooperative action for selling farm products has been a continuing element of our marketing system.[9] The Grange movement of the 1870's, the rapid organization of elevator or grain-shipping companies in the Middle West, and the necessity of forming cooperative associations for shipping western fruit all gave impetus to the movement. Later it became of importance in marketing milk, cotton, a wide line of fruits, eggs, tobacco, wool, and such minor products as nuts, beans, forage crops, potatoes, rice, and peanuts.

[9] Cheese makers of Wisconsin practiced cooperation as early as 1841 when they pooled milk in order that the large "ring cheese" type of Swiss cheese might be produced. Similar cooperation existed in Massachusetts in 1835. The first true cooperative in shipping livestock dates from 1883, and the first in grain, from 1867. The same year, 1867, witnessed the birth of the first cooperative for shipping fruits and vegetables. Cooperative action in selling eggs began when the Illinois State Grange sponsored an Exchange in Chicago in 1874. H. H. Bakken and M. A. Schaars, *The Economics of Cooperative Marketing* (New York: McGraw-Hill Book Co., Inc., 1937), pp. 47–63. See also *Cooperative Marketing,* Report of the Federal Trade Commission (Washington, D. C.: Government Printing Office, 1928), p. 7, which shows that the first experiments in cooperative marketing in this country date back to 1810 when Connecticut farmers attempted to make and sell butter cooperatively. Successful results of such cooperation, however, are traced only to 1841.

For a few years in the early 1920's, the movement spread very rapidly. Its advocates pointed to the marked success of cooperative selling by California farmers and advocated the same method for such staple crops as cotton and tobacco, which up to that time had not been so used except in isolated instances. The movement was accelerated during the farm distress years of the 1920's. By 1929 there were more than 10,000 cooperative associations, and by 1931 the number reached 12,000 which was the greatest total number of associations ever recorded. Throughout the remainder of the 1930's cooperatives declined in number, membership, and in sales volume importance. Several reasons explain this. First, many cooperatives founded in the 1920's and early 1930's were not well conceived, nor were they efficiently managed. When it was discovered that they were unable to attain the objectives sought by members, they passed out of existence. Second, increased use of motor truck transportation eliminated the need for many local market facilities and thus contributed to substantial decreases in the number of local livestock and grain cooperative shipping associations. Third, as the federal government began to play a more active role in controlling agricultural production and farm prices, farmers benefited whether or not they were members of cooperative marketing organizations.

Recent important developments have been characterized by a continuing trend toward a smaller number of associations but with a larger membership per association and a larger total membership in all associations. In 1953, there were 6,489 cooperative marketing associations with a total membership of about 4,250,000, as compared with more than 10,000 associations with only about 2,600,000 members in 1929. These associations transacted a gross business amounting to $9.3 billions in 1953, of which $7.4 billions represented the value of farm commodities at the first level at which cooperatives transact business for farmers.[10] This amounted to about 23 per cent of total cash receipts from all farm marketings. About 85 per cent of the total cooperative marketing business is accounted for by the sale of grain, dairy products, livestock, and fruits and vegetables. Well over half of this business is done by associations in the North Central States and about one-eighth is accounted for by cooperatives in the Pacific Coast States. The remainder is widely scattered, with some associations located in every state.

Types of Cooperative Marketing Associations. Cooperatives are classified into three groups: local, centralized, and federated associations. *Local associations* account for more than 90 per cent of the total number of such cooperatives, although many of them are affiliated with a federated association as explained below. They operate facilities in local growers' markets

[10] Anne L. Gessner, *Statistics of Farmer Cooperatives* (Washington, D. C.: U. S. Department of Agriculture, Farmer Cooperative Service, 1955), Tables 5 and 9. Figures pertain to the 1952–53 crop year.

which are conveniently accessible to their members. Examples are livestock shipping associations, creameries, farmers' elevator companies, citrus fruit associations, local cooperative creameries, and some apple shipping associations of the Northwest. Early cooperatives were all organized on this basis, inasmuch as they were formed by the initiative of farmers in the local markets and sought to eliminate abuses existing in those specific markets. This type of association owns its physical equipment, usually sells on a central market without cooperating with other associations and, in general, functions as an individual business enterprise.

Central associations differ from locals in that they cover a wide territory and ship from many local points. Local shipping or processing facilities are owned and controlled by the central association, and farmers become members of it rather than of a local association. Central associations are commonly used in marketing commodities which require rather heavy investment in processing plants, and for this reason farmers are usually tied to the central by contracts. One set of officers, supplemented by management representatives at local shipping points and at processing plants, conducts the business. Records are centralized and pooling operations are conducted for the entire area covered by the central association rather than for each local group. Strong centrals are found in the marketing of prunes, potatoes, cotton, eggs, and apples. Several attempts have been made to operate central associations for grain marketing, but, in general, they have not succeeded.

Federated associations are combinations of local associations, each of which operates its own local assembly facilities, but are joined together for cooperation in other activities, principally processing operations that require expensive facilities, advertising, selling, and the collecting and dissemination of marketing information. This type has often been developed in regions where locals were active before the need for a wider basis of operation was apparent. It is often associated with the marketing of consumer farm produce, where advertising of a specific brand is feasible. There are not many organizations of this kind, but their sales-volume significance is great since each represents many locals.

Vertical Integration by Marketing Cooperatives. Central and federated associations have exhibited a marked tendency to integrate vertically, gradually assuming functions normally performed by manufacturers and wholesale market middlemen. One of the most important facets of this has consisted of demand-creation activities which, in some notable instances, have greatly expanded the total market for certain consumer farm products. The advertising, sales promotion, and public relations activities of Sunkist Growers, Inc., a leading federated association, have been instrumental in greatly enlarging the market for oranges and lemons. Other familiar brand

names successfully promoted by cooperative associations include Land O'Lakes dairy products, Diamond walnuts, Eatmor cranberries, Ocean Spray cranberry sauce, and Donald Duck citrus juices.

A second aspect of vertical integration consists of processing or manufacturing. While some cooperative processing activities are simple and are merely incidental to local market handling, as is the case with cotton ginning, many involve the manufacture of finished consumer goods. Illustrative are the operation of food canning plants and frozen food processing establishments.

Third, many central and federated associations operate their own marketing facilities in areas distant from points of production. Livestock and grain federations maintain commission firms in terminal markets for these commodities. Pacific Coast egg producers are represented by a central sales agency in many major markets. In 1954 a group of cooperatives marketing miscellaneous fruits and vegetables united to purchase a large sales agency, American National Foods, Inc., for the purpose of cooperative national marketing of the produce of association members.

Cooperative Purchasing of Farm Supplies. A closely related field of cooperative activity consists in the operations of associations which are engaged chiefly in purchasing farm supplies for their patron members. The objective of such associations has been to provide farmers with high quality materials at prices lower than those paid to independent marketing middlemen. Growth has been stimulated by a long-run trend for farmers to grow or raise less of their production input items and to purchase a larger proportion off the farm. Some engage in the manufacture of farm materials which are sold direct to farmers in the local area and through other purchasing cooperatives or sales agents in other areas. Others operate a regular mercantile establishment, carrying on a business somewhat similar to the industrial distributor in the field of manufactured industrial goods.

In 1953 there were 3,376 cooperative farm purchasing associations. They purchased and resold more than $2 billions of farm equipment and supplies, distributed as follows: feed, 42 per cent; petroleum products, 22 per cent; fertilizer, 11 per cent; seed, 5 per cent; farm machinery and equipment, 4 per cent; building materials, 3 per cent; insecticides and fungicides, 1 per cent; containers, 1 per cent; and miscellaneous supplies, including some items for household consumption, 11 per cent.[11]

Methods of Cooperative Marketing Associations. Certain unusual features distinguish cooperatives from ordinary business corporations. Of especial interest are the form of organization, the policy of pooling, and the use of contracts.

[11] Anne E. Gessner, *Statistics of Farmer Cooperatives,* op. cit., Tables 1 and 13.

Organization. Control of the cooperative is usually democratic and is achieved by the one-man, one-vote principle, whereas in the usual corporate enterprise voting is on the basis of the number of shares of stock owned. Democratic control by patron-members may also be attained by limiting the amount of stock a person can hold or by voting on a patronage basis in order to give more important patrons a larger voice in management. Dividends on shares are usually paid at a fixed rate approximating commercial interest rates. Earnings, instead of being distributed entirely on the basis of stock ownership, are divided largely on the basis of patronage and are known as patronage dividends.

Pooling. A common characteristic is the use of pools. In a citrus cooperative, all receipts of oranges of a certain size and grade are placed in one pool for a definite time. Each member is credited on the books of the association for all fruit of each size and grade contributed. Careful record is kept of the proceeds from the sale of each size and grade. When all returns are made, the entire sum received for any one grade and size is divided by the total number of boxes of the size and grade in question and a pool price for the lot is thus determined. This factor is then used in calculating amounts due to members. This procedure is used in shipping any farm product subject to grading.

One of the principal reasons for pools is the impracticability of keeping each member's produce separate. Hence it is necessary to establish a common denominator of price for use in making payment. Another reason is that many shipments are made at different times during the season. If the price proves to be higher at one time than another, each member could claim that it was his shipment that was sold, or should have been sold, on the day the price was high and not when the price was at the lower levels. Pooling overcomes this by giving each member his share of high prices and low prices.

Although a traditional cooperative marketing policy, pooling is not universal. In some associations, produce is purchased outright from members at time of delivery, in which case the cooperative assumes market risks and operates as a merchant middleman. This has often been done by grain, cotton, and potato cooperatives. In other instances, the produce of individual members is separately identified and consigned for sale so that each member receives the exact price for which his goods were sold, less marketing charges. This has been common among grain and livestock cooperatives that maintain their own commission selling agency in central markets, thus operating as functional middlemen. Such departures from cooperative pooling represent attempts to meet the competition of private buyers or to keep members satisfied.

Contracts and Cash Advances. Cooperatives that maintain expensive physical facilities for grading, packing, or processing, usually find it necessary to use a contract which calls for each member to deliver produce to the association during the contract period or pay a certain amount per unit to the association for all units sold elsewhere. Sometimes agreements are so strict as to give the association the right to enforce specific performance of the contract, by injunction if necessary. Some such provision is necessary inasmuch as plans are made on the basis of handling the total crop of members.

Partial cash advances are commonly made to members when they deliver their crop, because under pooling returns would otherwise be delayed several weeks or months. As sales are made from time to time, other advances are given but final distribution obviously cannot be made until the pool is closed. In other cases warehouse certificates are given to members which may be used as collateral for loans from local banks. This practice is common among cotton associations.

Government Aid to Marketing Cooperatives. The federal government has done much to aid agricultural cooperative marketing associations. In much of the farm legislation enacted from the 1920's through the mid-1950's, special provisions are to be found which facilitate the formation and growth of such associations. This may be illustrated with reference to several specific laws which provided unusual impetus to cooperative marketing. The Capper-Volstead Act (1922) permitted farmers and marketing associations composed of farmers to combine and form marketing agencies in common, without being subject to the federal antitrust laws for so doing. The Cooperative Marketing Act (1926) directed the Department of Agriculture "to promote the knowledge of cooperative principles and practices and to cooperate, in promoting such knowledge, with educational and marketing agencies, cooperative associations and others." This act is administered by a special agency, the U. S. Farmer Cooperative Service. The Agricultural Marketing Act (1929) encouraged cooperatives by providing for cash advances to be made to them from federal funds at exceedingly low rates of interest. Such funds were to be used to aid cooperatives in withholding crops from the market at times when prices were low, thus permitting later sales under more favorable conditions. The financing of cooperative associations was greatly aided by the Farm Credit Act (1933) which provided for the establishment of twelve regional banks for cooperatives and a Central Bank for Cooperatives to make loans to farmers' associations.

Whether the government is justified in providing such aid to cooperatives is a question that has been vigorously debated, both without and within the agricultural community. Regardless of individual points of view, it is apparent that public policy since 1922 has been that of fostering cooperative

marketing by farmers and there is every indication that this policy will be continued.

Principles Established by Experience. When one realizes that cooperative marketing associations have been an important and integral part of our distributive structure for more than two generations and with very few exceptions are still far from the dominant influence in the movement of products from farm to wholesale markets, he is justified in asking what principles have been developed by the experience of these years which may act as a guide or standard by which to forecast further developments in this important sector of marketing.

The first principle is that *cooperative marketing is best adapted for selling agricultural products for which demand must be wholly or partially created, by collective advertising to consumers.* Thus the greatest success has so far been attained in the sale of citrus fruit, grapes, walnuts, raisins, avocados, California and northwestern apples and prunes, pears, and eggs. Many of these products were once considered luxuries by the majority of consumers and had a very limited use. Pooled resources of thousands of growers made it possible to conduct advertising campaigns, develop merchandising methods, and provide reliable sales representation in eastern markets. The result has been a greatly increased demand for the products mentioned. It is unlikely that cash buyers in local markets, or unorganized brokers or commission houses in wholesale centers—the alternatives to cooperative marketing—would have been able to carry out any important form of demand creation. The validity of this principle was further established when in the early 1920's rapid expansion of the cooperative form of organization failed to bring gains for sellers of cotton, wheat, wool, and livestock at all comparable to those secured by producers of specialized and nonstaple crops intended for ultimate consumers.

A second principle taught by experience is that the economic performance of essential marketing functions is the primary avenue to reduced marketing costs. Thus when cooperative associations take over the function of shipping crops to market which has been previously performed by private middlemen, they do so only because they believe that they can carry on such a function more economically. The fact has been definitely established that *marketing functions are not eliminated when cooperation is substituted for private enterprise.* Over-enthusiastic advocates of cooperation in the early years of its development predicted a drastic reduction in the cost of marketing farm crops and correspondingly higher returns to shippers. Farmers soon discovered that there was no magic in cooperation per se and miraculous reductions in cost could not be attained. Consequently, many lost interest and reverted to sales to private buyers.

Third, *cooperative marketing tends to reduce certain types of marketing wastes and trade abuses.* Before the development of group action it was common to find too many or too few middlemen in numerous local assembly markets. When there were too many independent buyers in a given market, the available business was divided to an uneconomic degree, often at the expense of agricultural producers. Some of the achievements of marketing cooperatives in the grain trade are attributed to the construction and operation of elevators larger than those formerly operated by numerous independent merchants in the same region, thus permitting a more economical utilization of physical facilities and personnel. When the number of buyers was too small, the farmer was often at the mercy of the purchaser. Many dairy farmers found that they could not bargain satisfactorily in markets where there was but a single creamery, but were able to obtain better prices when their milk or cream was pooled in a cooperative that controlled a large supply and could bargain on an equal footing with purchasers. Cotton farmers with but a single cotton gin available to them locally sometimes found that excessive charges were levied, but the formation of a single cooperatively owned cotton gin in one community has sometimes resulted in more reasonable charges throughout a wide area.

A fourth principle is that *only certain types of farmers are adapted for membership in cooperative associations.* Surrender of individual points of view, merging of personal interests in that of the group, and the necessity of contributing time and labor that planned objectives may be realized constitute a program which does not make a strong appeal to all farmers. It has been said that farmers as a class tend to be individualistic and are not cooperatively minded. Doubtless such a statement was more generally applicable to a former generation, yet the fact remains that many farmers even today are not intrigued by a program for increasing the well-being of agriculturalists as a class or do not believe that cooperation is the best method of securing such results. They are more interested in knowing what a marketing program means to them as individuals. Too often cooperation failed to yield immediate dividends and losses in membership followed.

Finally, it has become apparent that *cooperatives can be operated most successfully in highly specialized producing areas.* Substantial areas in Southern California and in Central Florida are almost totally devoted to the production of citrus crops, and a large part of Wisconsin is characterized by concentration in dairy farming. In such instances, farmers have a great homogeneity of interests, growing out of the common problems of producing and marketing one particular type of commodity. This has favored cooperative action to an extent rarely, if ever, encountered in areas of highly diversified farming, where individual farmers are concerned with marketing a variety of crops and the marketing problems of different farmers vary considerably.

Conclusion. When consideration is given to the conditions just expressed in the form of principles, one may venture to assert that although cooperative marketing of farm products will remain an important part of the marketing picture and may increase in importance, there is little reason to believe it will become the dominant factor. To this, exceptions may be found in the distribution of crops for which there remains a demand creation function or for which a coordinated merchandising program is essential.

Most cooperative leaders have abandoned an earlier concept, that of a semi-monopoly control of price through regulating the flow of farm products to market. Much has been accomplished by financing farmers through cash advances and thus allowing them to hold their crops for a favorable selling period, but the idea has stopped short of withholding supplies until a designated level has been attained. Yet this was a definite part of the thinking of earlier leaders. Rather, it has come to be realized that much can be gained by using the costs of cooperative marketing as a yardstick by which to judge the effectiveness of private agencies. If such agencies seem to be taking too great a portion of the selling price for their services, cooperatives can be set up. Otherwise it may be the part of wisdom to let private initiative thrive. Good business management, supplemented by practical judgment, is just as essential to the success of a cooperative as it is in the operation of a private business enterprise. If any unusual growth should be experienced in the cooperative field, it is more likely to be in response to impetus given by government action.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   - *a*) local assembly market
   - *b*) terminal market
   - *c*) dispersion market
   - *d*) commodity exchange
   - *e*) assembling wholesaler
   - *f*) local cooperative
   - *g*) central association
   - *h*) federated association
   - *i*) purchasing cooperative
   - *j*) pooling
   - *k*) parity
2. What are the special characteristics of agriculture that distinguish it from manufacturing? Explain how these characteristics give rise to unusual degrees of emphasis upon certain marketing functions.
3. Explain how the Commodity Credit Corporation has supported the price of so-called "storable" commodities. Of perishable commodities.
4. Describe the structure of markets associated with the traditional flow of farm commodities. How can you account for a trend to bypass terminal markets in this flow?
5. Describe the kinds of institutions generally found in a central or terminal market. Is there any difference between terminal markets for consumer farm produce and industrial raw materials, in terms of location factors? Explain.

6. How can you account for the major emphasis upon the use of middlemen in marketing agricultural raw commodities, as compared with the predominance of direct channels in the marketing of manufactured industrial goods?
7. Why has there been a decline in commission dealing in consumer farm products? What measures have commission men taken to maintain their business?
8. What major classes of farm commodities are most commonly sold by the auction method? Can you explain why auctions are used for these commodities and not for others?
9. What are the major advantages and disadvantages of auction selling?
10. In what respects do the operations of "assembling wholesalers" and "produce jobbers" differ from those of regular general-line wholesalers of manufactured consumer goods?
11. Give examples of several types of situations in which farmers market goods in accordance with advance contract arrangements. Why are contracts important in these cases?
12. How do you account for the fact that cooperatives in the marketing of agricultural products have gained a considerably more important position in that area than consumers' cooperatives gained in the retail field?
13. In what major respects have agricultural marketing cooperatives tended to integrate vertically? Explain.
14. Explain the major principles that have been evolved from experience with agricultural marketing cooperatives.
15. Does it appear to you that the government gives more marketing aid to farmers than to manufacturers and middlemen? If so, is this fair to the latter groups? Explain.
16. Legislation is being proposed in your community to prohibit the entry of truck buyers' vehicles to the local market. As an operator of one of these types of wholesaling institutions, what points would you bring forth if you were selected to appear before the legislative body in defense of truck buyers?
17. A city of 55,000 is contemplating the establishment of a fruit and vegetable auction. Two wholesalers and three buyers for small regional chains have expressed interest in such a venture. If you were hired as a market consultant, what would be your advice?
18. A group of farmers in Tobacco Row County have decided to pool their tobacco. They are skeptical about the local auction and are not satisfied with prices offered by the local cash buyer. What factors should a prospect consider before agreeing to pool his crop with these farmers?
19. R. T. Poole is a large Georgia peach grower interested in cooperative marketing. His orchard is located in a section producing a large percentage of the peach crop. At present peaches are marketed individually by orchard owners. Poole feels that advantages are to be gained by working together. Draw up a plan for a cooperative marketing organization for these peach growers. Explain how such a plan would work and the benefits to be derived therefrom.

20. Farmers in a particular section of the western fruit growing country were not getting what they thought were just prices for the apples they produced. They were easily persuaded to organize a local cooperative marketing association. Grading and spraying equipment purchased by the society soon proved its worth by improving quality. Bargaining power created by handling larger quantities, along with the better quality product, made for better returns on the farmer's investment. However, the increase in returns was not as high as expected by the members. Other marketing associations were getting better prices for fruit of identical quality, so local association members began to drop out in favor of the other societies. It seemed that the local cooperative was doomed to be just another unsuccessful experiment. How can the service of this cooperative be improved in order to hold the members to the association?

V

FUNCTIONAL ANALYSIS OF MARKETING

19

THE BUYING FUNCTION

In the two preceding parts of the book the field of marketing was treated mainly in terms of structure. While functions, policies, and all other aspects of marketing were considered in the detailed discussion of the major retailing and wholesaling institutions, emphasis was of necessity upon the mechanistic and structural parts of the marketing system or process. In this part of the book the subject of marketing is treated mainly from a functional standpoint, with structure and institutionalism occupying a subordinate position.

From the very definition of marketing as presented and discussed in Chapter 1 the functioning or physiology of the marketing system or process must be of vastly greater significance than its structure or anatomy. Basic reasons for such a conclusion were presented in Chapter 2, which also included a discussion of the nature and significance of marketing functions. A functional treatment is thus essential to a proper understanding and evaluation of the marketing system both in the light of social objectives and in the interest of the individual enterprise engaged in some phase of marketing.

For the sake of clarity it may not be amiss to repeat at this juncture that a marketing function is viewed in the sense of a major economic activity, inherent in the marketing process, pervading it, and, through a division of labor, tending to become specialized. Categorically, these functions may be listed and classified as follows:

A. The Functions of Exchange
   1. Buying
   2. Selling
B. The Functions of Physical Supply
   3. Transportation
   4. Storage

C. The Facilitating Functions
   5. Standardization
   6. Market Financing
   7. Risk-bearing
   8. Marketing Information and Marketing Research

All these functions are universal in the sense that they are performed, at least to some degree, in the marketing of all types of tangible commodities. Regardless of the institutions involved in the marketing of any commodity, the functions are inescapable. Whether the channel of distribution be long or short, simple or complex, these pervasive major economic activities remain essentially unaltered.

Buying—An Active Marketing Function. While buying is a basic marketing function, it is often improperly relegated to an unimportant position. It is sometimes erroneously assumed that it is of a *passive character*—merely the opposite of selling. Quite to the contrary, buying does not take care of itself, but is indeed an *active* function.

The skill used in buying has an important influence in determining the relative value of what is purchased by the consumer. The constant increase in the variety of goods offered to him, the growing tendency to procure more goods and services in the market rather than to produce them in the home, the multiplicity of brands, the frequency of relatively small quality differentials, and the widely differing services offered by stores, all combine to add to the difficulty of the consumer's choice and to stress the importance of his being able to buy with intelligence.

The active character of buying is especially conspicuous in the case of the consumer. Traditionally, he has taken the initiative in the exchange process. When wants are recognized and the consumer is ready to act upon them, it is customary for him to seek out a seller or sellers. When a salesperson comes into contact with the consumer-buyer, the process of exchange is often nearly completed. This is dramatically emphasized by the small proportion of retail business which is accounted for by house-to-house canvassers or other sellers who take the initiative in seeking out prospective consumer-buyers, and, by way of contrast, by the predominant proportion which is accounted for by regular retail establishments that are visited by a purchasing-minded public. Developments in simplified selling or self-service merchandising accentuate the importance of consumer buying activity. *The more the retail selling and service functions are curtailed, the greater becomes the task and responsibility of the consumer as a buyer.* While there is a substantial amount of pre-buying stimulation in the form of aggressive retailer and manufacturer advertising and sales promotion activity, the number of items competing for consumer attention is so vast and diverse that the ordinary person must play an extremely active role in making the

purchases that satisfy his wants. Because of the detailed treatment of consumer demand and motivation in the early part of this book, the discussion in this chapter is devoted substantially to buying by business firms. It may be observed, however, that buying is often as active when examined from the standpoint of the firm as it is in the case of the ultimate consumer.

Unless buying of raw materials, semi-manufactures, and the many items of equipment and supplies needed for the production process is effectively accomplished, manufacturers handicap themselves in their ability to compete with those who may be more skillful in the performance of this function. Ability to select from many offerings just what will sell best and to determine the most economic quantities to be bought at a given time is one of the prime tests of the efficiency of both wholesaler and retailer. Moreover, buying is closely related to other marketing functions. Its practices and policies are often determined, in part at least, by the financial position of the purchaser, the availability of adequate and economical transportation and storage facilities, and the degree to which standardization has been accomplished. Risk is often reduced by the adoption of proper buying policies. Skillful buyers make use of reliable and pertinent market information from a variety of sources. Goods purchased for resale must be selected primarily with reference to what the market will absorb. In short, this marketing function is closely related to the functioning of almost every part of our marketing system.

That buying is a very active function and of substantial quantitative importance cannot be questioned when it is considered that manufacturing companies and middlemen ordinarily employ specialists to perform this activity. In manufacturing establishments a key employee, generally known as the purchasing agent, sometimes bearing the title of Vice President in Charge of Procurement, is responsible for the function. All wholesale merchants have buyers who generally occupy the position of executives, the number depending upon the size of the business and the number of different merchandise departments involved. Larger retail stores employ buyers who are also usually the managers of merchandise departments. Quite a number of our larger department stores have more than 100 buyers each. In the chain store field the buying function is either centralized or divided between the central office and the individual retail store unit. Among smaller independent stores, the buying function is usually the responsibility of the proprietor or one of the partners, but it is almost invariably one of the most important of their activities.

What Buying Involves

Like the other marketing functions, buying may be subdivided into a number of important elements or responsibilities. The most important of

these are (1) the selection of kinds of goods, (2) the determination of quality or suitability, (3) the determination of quantities, and (4) the selection of sources of supply. Each of these four major responsibilities is examined in the following paragraphs.

Selection of Kinds of Goods. The degree of freedom which is available in determining the kinds of goods to be purchased varies from one type of business to another. In many lines of manufacturing the materials to be bought are fixed automatically by the nature of the product manufactured. The manufacturer of cotton textiles must buy cotton yarn or raw cotton. Similarly, the manufacturer of pig iron must purchase iron ore and the butter manufacturer must have cream. Installations and industrial equipment are determined largely by the nature of the manufacturing process, with the result that there is rather limited freedom in their purchase.

For most merchants, on the other hand, the determination of kinds of goods to be purchased is a real problem, since the firm may not constantly handle exactly the same merchandise. While within certain limits most wholesalers and retailers find their choice of merchandise circumscribed by their clientele and competition, nevertheless it is a rare mercantile business which does not have some latitude. The department store may have to decide whether to handle automobile tires and accessories, the grocery store whether to handle a limited line of notions or to add a bakery department, and the hardware store whether or not to purchase a stock of ornamental shrubs. Such problems are most difficult of solution in the case of those businesses which are rapidly changing and expanding, or where the decision involves handling goods not customarily sold by the type of store in question in that community.

This problem has been aggravated considerably by a pronounced tendency for many types of stores to expand or diversify their merchandise lines. Self-service grocery stores, for example, have sought to handle any type of merchandise that is suitable for sale by self-service methods. In seeking new items to purchase, they have been attracted by the higher margins obtainable on numerous items normally handled by drug-, department, or hardware stores. As a result, the sale of advertised brands of proprietary remedies, toilet preparations, cosmetics, housewares, magazines, and alcoholic beverages have been successfully added to the lines carried by many supermarkets. Drugstores, hardware stores, and other kinds of business, feeling the pressure of this competition, have also sought to expand their offerings by invading fields hitherto foreign to them. Similarly, variety chains appear to have abandoned their limited-price position, and some have become in essence junior department stores. Department stores, in turn, have expanded their sales volume by the addition of departments for sporting goods, cameras and photographic equipment, and other kinds

of merchandise that have been sold traditionally in specialized types of establishments.

Many marketing establishments have made costly mistakes in experimental attempts to diversify their merchandise offerings. For most small establishments, experience has indicated that new items cannot ordinarily be added successfully *unless* (1) they are in keeping with the general character of the business as reflected by firm name, atmosphere, location, and advertising and promotion policies; (2) they can be sold according to the present method of sale and by present employees; and (3) sufficient space and capital investment can be devoted to the new merchandise to offer customers a reasonable range of choice within the classification to which it belongs. Obviously, these rules have not been important limiting factors for very large wholesale or retail firms where it is more feasible to add specialized personnel or facilities to handle the merchandising of items not closely related to those previously sold.

Determination of Quality. A second major buying responsibility relates to the determination of the suitability of goods for production purposes or for resale. This is a matter of quality, which involves consideration of materials, workmanship, grades, sizes, designs, colors, and patterns.

To a large degree manufacturers determine the quality of goods purchased by the characteristics of the products they make. Furniture sold in the highest price ranges demands raw materials far different from those used in making furniture to sell on a price basis. Although the final product depends greatly upon the skill of craftsmen assigned to its production, minimum qualities of raw materials must be established. The maker of low-priced men's suits is obviously interested in the price of "shoddy wool," a market fact which means little to the maker of quality woolens, except as the price of virgin wool is affected by the price of its substitutes. But in many lines of manufacturing there is an opportunity to exercise choice in selecting qualities for purchase. Sometimes additional labor may be applied to cheaper raw materials with resulting equal end results and a net cost reduction. While the specifications for materials are usually dictated by the requirements of the product being manufactured, final product design is often determined, at least in part, by the prices at which materials of varying qualities can be purchased.

Determination of quality is of especial interest in the purchase of business supplies. Good purchasing practice involves obtaining the *right quality for a particular purpose*—not the highest obtainable quality. This may be illustrated with respect to paper which is available over a wide range of quality. To purchase such a product which is either not good enough or better than necessary involves potential waste. Take the case of a large insurance company that has substantial paper requirements. For inter-

office communications that are promptly read and quickly discarded, only minimum quality standards need be observed. For documents which will be kept a long time and handled often, however, much attention must be given to various quality factors which are relevant to preservation.

Retailers and wholesalers have a somewhat similar problem. Their market must be analyzed to determine the quality of merchandise which will appeal to prospective buyers. Often such a study reveals that a considerable part of the community desires either higher or lower qualities than are being supplied by the stores. Not only must quality be determined, but merchants must give careful consideration to the salability of various sizes, materials, patterns, colors, and designs before entering the buying market.

Consumer demand is not, however, the sole consideration in determining just what qualities to buy. This may be illustrated with respect to the marketing of fresh peaches. Generally speaking, the consumer wants peaches which are ready-to-eat when purchased and prefers those that are picked from trees in a near ripe state. In the very early part of the season, however, peaches are usually quite expensive and sell rather slowly on both wholesale and retail levels of distribution. At this time, produce jobbers and retailers wish to buy peaches which are picked green because they will keep longer and can be handled with less risk of damage or spoilage. Thus, quality considerations are dictated by cost and handling factors rather than by consumer preference. Later, as supplies become more abundant, prices decline, and the volume of sales increases markedly. Both wholesalers and retailers are then more willing to handle peaches which have been picked in a more mature state and which are more satisfactory to the ultimate consumer.

A somewhat similar situation exists in ready-to-wear apparel establishments and other stores selling style merchandise. Consumer demand may dictate quality decisions for the most part, but in some instances there are other reasons for purchasing a given quality. Some retailers will buy a few items of more expensive quality than can be readily sold to their clientele. Their reason may be that the highest priced items make the next higher priced items in the line appear less expensive by comparison. Another motive may be to use the higher quality items chiefly for prestige purposes—i.e., for display to give the store more of an atmosphere of quality and fashion leadership than it would have if it confined its offerings solely to qualities that it can merchandise profitably. All of this suggests the wisdom of not confining motivation research to consumer-buyers or to industrial users, but of extending it to buyers of consumer goods on both the retail and wholesale levels of distribution.

Measuring Quality. While it is very important to determine the desirable quality before buying, it is equally important to ascertain just what quality has actually been supplied by a seller. When quality factors are related

to considerations such as flavor, visual appeal, or fashion, tests of quality are confined substantially to the judgment of the purchaser. Many aspects of quality are, however, precisely measurable. The process of analysis is used to determine the composition of an alloy or the purity of a chemical substance. Physical tests are employed to obtain the tensile strength of metal or the bursting strength of paper cartons. Precision measurements are used to find out whether the thread count of woven fibers or the thickness of sheet steel are within stated tolerances. Tests of performance are appropriate to determine how well paint will wear on a surface or how well automobile tires will last in use.

Many manufacturers utilize their own testing facilities for this purpose; others employ commercial testing laboratories. In some cases the test is made to determine the effective price, which may depend on the quality actually delivered. More often the test is made to prevent acceptance of products the quality of which is lower than was ordered. Many large retailers have installed testing laboratories for similar reasons, realizing that they must know the quality of merchandise which they sell if they are to serve their customers well. Certain trade associations perform a similar service for their members.

Determination of Quantities. A third important buying responsibility is ascertaining the proper quantities to be purchased. In wholesaling and retailing concerns this is based upon planned sales, and in manufacturing enterprises it is based upon production schedules which are ultimately dependent upon the sales volume anticipated. In some manufacturing businesses production is altogether or largely based on orders already received and little or no production for stock takes place. In such instances, the manufacturer may defer the purchase of raw materials until he has orders for his product. Most manufacturers, however, cannot defer the purchase of all materials until they have orders in hand, since to do so would mean undue delays in the delivery of the products. All merchants are forced to carry some stock, and most merchants must carry substantial inventories. For them quantitative considerations in purchasing must rest upon estimates of future sales.

The sales estimate may be made directly in terms of numbers of units of merchandise to be sold, i.e., dozens, hundreds, pounds, barrels, tons, etc., or first in terms of dollars and cents. Expressing planned sales in money is a convenient common denominator for indicating total potential sales of a diverse and varied line of merchandise. The sales estimate or plan in terms of dollars becomes a valuable "yardstick" for measuring actual sales against planned sales. Obviously, where the manufacturer or merchant begins with a sales estimate in terms of value he must convert the dollar-and-cents figures into merchandise units.

In retail stores that handle fashion merchandise, careful sales plans are made twice a year, once for the spring and summer season and again for the fall and winter season. Planned purchases are derived from such estimates. For example, a shoe retailer may anticipate sales of $150,000 for the fall and winter season. If the merchant expects to realize a gross margin of 30 per cent of sales, then 70 per cent of sales or $105,000 may be spent to purchase shoes for this season. It would ordinarily be very bad judgment to spend the entire $105,000 before the season of retail sales arrived, since that would greatly increase the expense of operating the business through higher costs in interest, rent, and taxes. Moreover, possible losses through style obsolescence would be quite heavy. It is necessary, therefore, to decide just how the $105,000 in purchases is to be distributed over the period. That is, the buyer must decide how much merchandise shall be purchased or delivered before autumn and how much shall be spent for merchandise to be received during each of the autumn and winter months. If actual sales fall below the planned total, it will be necessary to curtail purchases. If actual sales exceed the planned sales, then additions must be made to the sum allotted for the season's purchases.

Most retail and wholesale establishments that deal in staple commodities do not find it necessary to formulate such sales plans in order to buy intelligently. The typical grocery, hardware, or drug store is supplied by wholesale firms in the vicinity and can obtain immediate replenishment for most items. Similarly, tobacco wholesalers reorder from manufacturers of cigarettes who maintain inventories in most major cities. Such merchants need anticipate their requirements only a short time ahead to determine quantities to be bought.

Quantity vs. Small-Lot Buying. While the total quantity to be purchased *over a period of time* is derived from anticipated sales volume, most manufacturers and merchants have considerable latitude in determining the quantity of goods to be ordered *at a given time.* Such decisions are often a matter of policy, determined after consideration of the advantages of placing large orders and the disadvantages of such a practice.

Among the various *advantages of quantity buying,* the ability to obtain merchandise at lower cost is a foremost consideration. Many sellers quote special prices on large orders because the costs of selling and shipping are relatively less than on small orders. Price concessions may take the form of lower list price quotations, extra discounts from list prices, or "free deals" involving, for example, an offer of one dozen units of free merchandise if a merchant orders a full gross at one time rather than a mere one or two dozen. Substantial transportation economies are often associated with large orders. This is especially true if a full carload or truckload is purchased instead of an ordinary freight shipment, or if a freight shipment

of 100 pounds or more is purchased instead of a smaller parcel post or express shipment. When large quantities are purchased, fewer orders are placed, which means that less time and effort may be required to perform the buying function, fewer incoming shipments need be received and checked, and there is a smaller number of invoices to be accounted for and paid. Quantity buying is often stimulated by speculative desires. This is especially true when market prices are rising, and buyers wish to profit thereby, or when conditions of scarcity are anticipated, as in a national emergency.

While it offers many inducements, there are also a number of *disadvantages resulting from quantity buying.* The practice may lead to a decreased stock-turn rate through a larger average stock on hand without a corresponding increase in sales volume. This, in turn, tends to accelerate depreciation both from physical deterioration and from style obsolescence. As against the possible speculative gains of quantity buying there must be offset the possible losses due to declining prices. Buying in smaller quantities gives more flexibility to the merchandising program, since the smaller inventories make it possible for the merchant to change his stock to bring it into conformity with changes in demand. Buying in larger quantities sometimes results in an inability to take advantage of late season bargains and other special opportunities. Furthermore, the larger stocks of goods which result from quantity buying practices spell higher costs of owning or carrying a merchandise inventory. Illustrative are greater interest costs on capital invested in inventory, larger requirements for storage space, greater insurance needs, and higher taxes on inventories.

Before adopting general policies concerning quantity or small-lot purchasing, businessmen must give careful consideration to all of the important factors involved. The advantages and disadvantages of quantity buying are largely corollaries of disadvantages and advantages of small-lot purchasing. Generally, quantity buying tends to reduce the net cost of the merchandise and the cost of acquiring it; small-lot purchasing, on the other hand, tends to reduce the cost of owning and carrying the merchandise. A keen appreciation of these opposing tendencies and their relative quantitative importance leads to the adoption of policies aimed at minimizing net total merchandise costs, acquisition costs, and inventory costs rather than focusing attention merely on one of these factors.

Selection of Sources of Supply. Those charged with the performance of the buying function have a fourth major responsibility in determining the firms from which purchases are to be made. If it be assumed that decisions regarding kinds, qualities, and quantities of goods have been made, and if buying decisions were altogether objective and impersonal, it would appear that suppliers would be chosen on the sole consideration of price. The lowest price, it might be argued, would point inevitably to one particular

vendor as the most logical source of supply, except where the same price is quoted by several suppliers which may be the case under conditions of either oligopoly or extremely keen competition. This sometimes holds true when an inflexible purchasing system is prescribed, as in the case of many government agencies where the purchasing agent must accept the lowest of a number of competitive bids. In business practice generally, many factors enter into the picture, often with the result of making this facet of buying a very complex one.

Factors Governing the Choice of Suppliers. Price is obviously a very important consideration, for different vendors often quote different prices on goods of varying quality. The vendor's price quotation must be considered in relation to transportation costs, if these are to be paid by the buyer, especially if suppliers are located at a considerable distance or if the goods are heavy or economically bulky.

The ability of a supplier to make *prompt delivery* is often most important. In some cases, this may be a prime consideration, as when repair parts are needed to keep from shutting down a factory. Retailers of fashion merchandise are willing to pay premiums for immediate delivery when the demand for a specific fashion is great and stocks are depleted. When prompt deliveries can be counted on, mercantile organizations do not have to anticipate demand so far ahead and can obtain higher rates of stock turnover.

Terms of sale sometimes vary among vendors and are considered in the selection of suppliers. Cash discounts, which are offered to encourage the payment of bills before the expiration of a regular credit period, are often an important inducement, especially to firms that are in a healthy financial condition. The length of the credit period (i.e., whether a week, 30 days, 90 days, etc.) is important to many buyers, particularly those in weak financial condition. A long credit period permits the buyer to sell much or all of the merchandise before the account is due, and to pay his obligation from the cash secured from the resale of the goods.

The vendor's general reputation for *reliability* is often a patronage-determining factor. This may relate to integrity in observing the terms of contracts, making deliveries on schedule, or supplying goods that conform with samples or contract grades.

Buyers are often influenced by the *distribution policies* of vendors. If a manufacturer sells direct to some retailers, some wholesalers may refuse to consider him as a source of supply. If a manufacturer operates some retail stores of his own, this may cause ill will among regular retailers, especially in shopping areas where the manufacturer's stores are located. Some manufacturers select only a few outlets for their products in each community, and many have only one exclusive representative. When a

retailer or wholesaler is so selected, he is likely to be more favorably inclined toward the seller than in a case where a seller distributes his product widely through a large number of competing establishments.

Sales promotion policies of vendors also influence their selection as sources of supply. A maker of women's dresses may purchase the fabric of a particular cloth manufacturer because the latter's consumer advertising will help in the sale of the dresses made from it. Some manufacturers win the favor of retailers because of the excellent assistance they provide in local cooperative advertising, point-of-sale display materials, demonstrations, direct mail advertising, or sales training programs for the buyers' employees.

The ability of a vendor to provide *continuity of supply* is often very important. Retailers do not like to patronize wholesalers who are often out-of-stock on important items and have to "back-order" them. In industrial purchasing, this factor is especially significant in connection with raw materials and supplies which are used regularly.

The selection of vendors is sometimes resolved on the basis of *reciprocity*. This is especially true in the industrial marketing field where large quantities are usually involved in a single transaction. Although this is not a scientific way of selecting suppliers, it is often rationalized by the attitude of "buying from those who buy from us, and thus we help each other." Just because a possible supplier is a customer does not mean that he is a good supplier on the basis of the more rational considerations explained above. Some companies carry a policy of reciprocity to the extreme. A manufacturing company, for example, analyzes its sales to oil companies and distributes its purchases of supplies such as lubricating oil to each company in relation to the approximate volume of each oil company's purchases from it.

When a number of different potential suppliers are all satisfactory on the basis of the factors herein considered, the actual selection of sources is likely to hinge on the human equation. The personality, character, and technical proficiency of the *vendor's salesman* is frequently the factor that swings the balance of decision from some alternatives to others.

Concentration of Purchases. Closely related to the question of selecting sources of supply is the matter of deciding the number of different suppliers from whom to make purchases. The practice of buying from one source or a small number of suppliers is known as concentration of purchases. Although often a phase of quantity buying, a policy which limits the number of suppliers is practiced because of certain special advantages. Price concessions other than regular quantity discounts, better terms of credit, special help from the wholesaler or manufacturer in solving merchandising problems, and an opportunity for prior selection of desirable merchandise

are often of enough importance to justify a policy of concentration. Moreover, such a policy tends to minimize the chance of overstocking, largely through a reduction in the number of brands, styles, patterns, designs, or price lines. Some retailers and wholesalers concentrate their purchases in order to secure an exclusive agency.

Concentration of purchases is an established practice by retailers who operate units of voluntary chains. Owners of Ben Franklin stores, for example, buy practically all their merchandise from Butler Brothers, the sponsoring wholesale house. A similar concentration of purchases takes place in the various voluntary groups in the grocery and automobile accessory store fields.

Rigid limitations on the number of resources is not, however, always a wise policy. Some wholesalers and retailers find it necessary to buy from many sources to secure the best assortment of style goods. Good buying strategy calls for alertness for special offers which often preclude concentration, because such offerings may come from suppliers not normally patronized or from newly established sources. Many industrial purchasing agents make it a policy to develop a number of supply sources for important materials to insure continuity of procurement under circumstances that might jeopardize normal operations. If a single supplier experiences a fire or flood, encounters unusual labor difficulties, or runs into problems in his own procurement of raw materials, the entire manufacturing operation could be disrupted. Even though a buyer makes it a practice to concentrate his purchases, he should not ignore the offerings of other vendors, since such offerings constitute an admirable check on the merchandise, terms, service, and prices of his regular suppliers.

Buying Practices

Various practices are followed by merchants in contacting resources, appraising their selections, and actually making purchases. Buying may be accomplished through visits to central markets where the resources are available, by negotiating with salesmen who visit the purchaser's premises, by means of trade registers and directories, or, in cooperation with other buyers who have similar needs, by delegating the authority for purchases to a central agency which is independent of the individual merchandising units.

Visiting the Market. In a number of lines of business, leading central markets have been developed, and these are regularly visited by merchants or store buyers who wish to make purchases. New York City, for example, is both an important manufacturing and buying center for women's clothing. Other cities such as Chicago, St. Louis, Dallas, and Los Angeles (Holly-

wood) are of importance as centers of supply for the same merchandise and are visited annually by merchants. The major market for furniture and home furnishings is in Chicago. Hundreds of exhibitors have offices and showrooms in this city in, or in the vicinity of, the Merchandise Mart, which is a famous market center with 93 acres of floor space. Other major furniture markets are Grand Rapids, Michigan; Jamestown, New York; and High Point, North Carolina. A Pittsburgh hotel is the center of buying activities for chinaware, art pottery, and glassware when manufacturers hold their annual show. Toys, gift shop merchandise, and office equipment are purchased at shows held in several centers. Many retailers visit important markets when attending trade association conventions since they can there inspect the offerings of many manufacturers, importers, and wholesalers. Shoes, jewelry, hardware, building materials, and auto accessories are examples of retail lines often so purchased. The general principle is that staples may safely be bought without inspection, but nonstandardized goods can be better selected after the offerings of many manufacturers have been considered during visits to market centers.

A number of considerations affect the frequency of visits to the market. Buyers from stores located in communities remote from central markets, even though interested in style merchandise, may go to the market but once or twice a year or not at all, while those near at hand make relatively frequent visits. Buyers from large firms usually visit markets more often than do representatives of the smaller houses. Retail stores which feature special sales at short intervals find it necessary to make frequent market trips to "pick up" merchandise for these sales.

Buying on the Purchaser's Premises. All kinds of business firms do a large part of their buying on their own premises. This kind of buying takes two forms—by mail orders and through suppliers' salesmen. Mail orders sent to suppliers are the least important for most organizations. They are usually based on catalogs furnished by vendors or information contained in trade registers and directories. Many retail stores and wholesalers use the mails for "fill-in" orders which are placed in the interval between salesmen's calls or visits to market centers. This method is also commonly used in industrial purchasing, especially for routine or occasional buying of supplies, tools, and stocks of repair parts.

Buying from salesmen is the second form of purchasing on the buyer's premises and is doubtless the most important single form of buying. Grocers, druggists, hardware merchants, and in fact practically all independent dealers in convenience goods buy most of their stock from wholesalers' salesmen who visit the store, or in the case of some voluntary chains, call on the telephone for orders. Much style merchandise, even that sold in the very largest department stores, is purchased from manufacturers'

salesmen who visit the store with samples of ready-to-wear items supplied by New York garment houses and other similar resources. Buyers for wholesale establishments, factories, and governmental units also spend a considerable amount of time with suppliers' salesmen who call at their offices, and a large proportion of their requirements is bought in this manner.

Group Buying. An important development in buying, particularly among larger retail stores, has been the growth of group buying. Based upon the idea of the *cooperative combination of orders from a number of stores* so that relatively large purchases can be made at attractive prices, the plan has resulted in tangible savings of considerable magnitude. Informal buying pools that massed the purchasing power of members were common in the grocery trade in the early 1930's but declined in importance with the advent of formally organized retailer-cooperative wholesale establishments and the expanding development of wholesaler-sponsored voluntary chains. In later years, the practice has been much more important among groups of department, dry goods, and apparel stores that have combined orders of many articles to the mutual advantage of all participants. Arrangements for group buying are often made by resident buying offices, a type of institution discussed in more detail later in this chapter. These arrangements include plans for group participants to visit the central market at the same time. Samples of the type of merchandise under consideration are collected and examined by the attending buyers who express their preferences by voting upon the various offerings. Usually all members of a group bind themselves in advance to abide by the will of some specified majority, often two-thirds of those involved. Quantities desired by the participants are then pooled into a combined order and a price is negotiated with the resource.

The principal advantages of group buying lie in the lower prices usually secured from vendors, the fact that the merchandise may be produced to specifications of the group and packaged or labeled with the group's brand name,[1] and the use of the combined judgment of a group of qualified experts in selecting merchandise.

Group buying has, however, met with only limited success. For this there are several reasons. First, some lines of goods must be selected with the particular needs of each store's clientele in mind. The pooled judgment of a group of buyers from different stores does not always result in the selection of just the type or style of goods which a given store needs. Second, many buyers have failed to cooperate fully in such purchases because of the tendency of the plan, if successful, to minimize the value of their individual buying skill. Third, some manufacturers refuse to make offerings to cooperative groups because sales can be effected only at such low prices as to make

[1] The "Aimcee" brand of the more than twenty large department stores that buy through the Associated Merchandising Corporation is the most familiar example of such a group brand.

the business unattractive. This reason alone has been enough to place a severe handicap on the operation of the plan.

Central Buying. An important buying practice, limited substantially to large multi-unit organizations, is that of central buying. Its distinguishing feature is that *authority and responsibility for purchasing are vested in a central office rather than in the individual operating units* involved. This practice is widely used by almost all types of large retailing chains, to a limited degree by independent retailers of fashion merchandise through arrangement with resident buying offices, to a considerable extent by multi-unit wholesaling and manufacturing companies, also by various governmental units that have a central purchasing organization for different divisions or departments.

In some shoe or apparel chain stores, for example, there are no buyers in the individual stores. Local store managers are chiefly responsible for sales and have responsibility for buying only to the extent of providing the central office with daily or other frequent stock control information that indicates the sales of various items and changes in the inventory situation. On the basis of reports consolidated from the various stores, the central office buyer makes all market contacts, handles negotiations with suppliers, and makes actual purchases. On the basis of individual store stock and sales reports, merchandise shipments are made to them as directed by central office personnel, either direct from factories or from a central warehouse operated by the chain. In the grocery, variety, and drug fields the practice varies from this pattern. Store managers or other key employees check the stock periodically and requisition or order merchandise as needed, but from warehouse stocks or catalog listings that have been made available through central office negotiations.

Similar practices are sometimes followed in industrial or governmental purchasing. A large manufacturer of automotive equipment may operate a number of different factories, widely scattered geographically. If each of them requires similar equipment, materials, or supplies, the individual requirements may be consolidated and purchased centrally.

Specific procedures used in central buying vary from one type of industry to another and often among different firms within a particular industry or trade. Regardless of variations in detail, central buying is generally adopted to obtain specific advantages which include the following: greater skill and specialization in the buying function than would be possible if each unit did its own purchasing; lower merchandise costs through the negotiating power which comes from consolidating the requirements of the various units; ability to take advantage of favorable market opportunities through continual contacts with suppliers; and economies in purchasing and accounting obtained by combining what would otherwise be a large

number of individual transactions, each entailing the same unit costs for office procedures.

Specification Buying by Contract. When a firm exercises rigid control over the quantitative and qualitative characteristics of an item being purchased, the practice is known as specification buying. This type of buying is quite frequently accompanied by a contractual arrangement in which the buyer agrees to purchase stipulated quantities of goods for delivery at periodic intervals or as requisitioned, and at prices which either are set forth in the contract or are to be established in terms of some formula which is incorporated in the agreement. Contracts sometimes involve commitments for a substantial proportion of the seller's total output and may cover all or a major part of the purchaser's requirements for a period of many months or even a year or more. Because of the rather substantial character of many such contracts, they are often negotiated through high-level executives of both parties. This buying practice is encountered in various segments of business, including retail chain and mail order companies which sell products under their own brand names,[2] wholesaling companies that feature private brands, manufacturing companies that require materials of certain specifications for further processing or for incorporation in their end product, and governmental purchasing units, especially the military organizations.

Various considerations underlie such contractual arrangements. In the case of manufacturers, the assurance of a continuing supply of raw materials at a predetermined price is often the dominant motive. On the part of some purchasers, contracts for periodic delivery of instalments may be dictated by a desire to secure quantity prices without assuming the burdens incident to carrying heavy average inventories.

Many merchants have also attempted to secure the advantages of quantity buying without assuming the disadvantages through placing contracts for the periodic future delivery of large orders. Some large retailing concerns, for example, enter into contracts calling for the delivery of a certain number of pairs of hosiery each month for a period of months. Such contracts involve careful manufacturing specifications. Colors and shades are usually not determined at the time when the original contract is made but are furnished by the buyer from time to time during the life of the contract. The manufacturer finds such an agreement advantageous in that it enables him to plan a production program and to buy raw materials more intelligently. At the same time the purchaser profits by securing a quantity price and an assured supply without increasing his average inventory and, by

[2] For a detailed treatment of this subject, see William T. Kelley, "Specification Buying by the Large-scale Retailer," *The Journal of Marketing*, January, 1954, pp. 255–65.

supplying currently a schedule of colors and shades, he is enabled to adjust his stock to shifting consumer preferences in color and shade.

Specialized Buying Agencies

The dynamic character of our marketing system is vividly illustrated by a number of agencies which have emerged as specialized buying institutions. Their economic justification rests upon ability to render a unique service at a low cost to a group of mercantile establishments that have common buying problems.

Resident Buying Offices. A well-established segment of our buying structure is the resident buying office. Principally serving department, dry goods, and apparel stores, these offices have largely supplanted private central market offices which were formerly maintained by a number of the larger independent stores. Resident buying offices developed for the purpose of supplying central market representation for merchants and of relieving them from the necessity of making frequent trips to central markets. Such offices represent many retailers in the same line of business, and because of this fact they are able to render many services at a relatively small cost. By means of a force of market experts constantly in touch with developments in the manufacturing area, the resident buying office is able to keep its client stores in touch with the best sources of supply. The office becomes the headquarters of visiting buyers who are guided in their purchases by office buyers of comparable lines. Style bulletins and other market information are sent to member stores at regular intervals and, in general, the office acts as their representative in the market. Some group buying and central buying is sponsored by resident buying offices, and many "fill-ins" are selected by its buyers for member stores.

Payment for the resident buyer's services by a fixed yearly fee is a common practice in this field, the amount being fixed by the estimated sales of the store during the period of the contract. Smaller stores are often served by resident buyers who receive their payment in the form of commissions on sales made for certain manufacturers. Resident buyers are an increasingly important factor in the distribution of ready-to-wear and certain dry goods lines. Distance from the market and the importance of style merchandise to the individual merchant are the principal factors determining the extent to which they are used.

Several hundred resident buying organizations are located in New York City in the so-called "garment district" in mid-town Manhattan. Many of the larger organizations have branches in other principal markets for fashion merchandise, including Chicago, Los Angeles, and San Francisco. Some

of the largest have extensive foreign buying facilities, which may include permanent branches in a number of foreign market centers.

Independent Purchasing Agents.[3] Several independent business firms, known as purchasing agents or purchasing companies, provide a buying and market information service for wholesalers of consumer goods and for industrial distributors. Typical is an organization in the wholesale hardware and mill supply trade which serves many wholesalers by locating sources of new, superior, or scarce merchandise and in other cases by securing attractive price quotations for them. Prices and pictures or descriptions of thousands of items are supplied to the wholesalers in the form of a loose-leaf price book. Whenever the client believes that he can do so advantageously, he places orders with the purchasing agent, who in turn transmits them to the proper supplier for shipment. Each client pays a monthly membership fee for the services thus rendered. Similar organizations serve hundreds of wholesale grocers.[4]

Purchasing agents of this type render an important service and constitute an important element in the distribution of certain lines of goods. Their freedom to develop and operate was somewhat curtailed by the Robinson-Patman Act, for this law forbade collection of brokerage fees from sellers except for services rendered to such sellers rather than to buyers. It had been the practice of the purchasing agent to collect brokerage fees from sellers and to remit at least part to their clients, a fact which gave the clients a price advantage as compared with their competitors who bought directly from the same supplier or through the regular broker who kept his entire brokerage fee. Prevention of this and other types of price discrimination was one of the primary objects of the law. The result has therefore been that membership fees must be large enough to cover the cost of the purchasing agent's service, a fact which has somewhat reduced his importance as an agent for placing orders but which has in no way lessened the value of the market information provided.

The Use of Brokers.[5] In many trades it is customary to employ a buying broker, whose function it is to bring buyer and seller together. A buyer

[3] The term "purchasing agent," as used in the following discussion, refers to an independent middleman and should be distinguished from the same term which is frequently used to designate the paid employee in charge of purchasing operations in manufacturing establishments.

[4] Examples of two leading organizations of this type are the Biddle Purchasing Company and the Oliver Bros., Inc.

[5] For a detailed discussion of the place of the broker in the marketing system and his operations, see Chapters 16 and 18. Purchases are also made by retailers and wholesalers through such other functional middlemen as selling agents, commission houses, and manufacturers' agents, all of whom are representatives of the vendor rather than the buyer. A detailed discussion of these marketing institutions is presented in Chapter 16.

some distance from the market or even one in the market city may employ a broker to locate advantageous sources of supply. For example, a baking company in a midwestern city employs a Chicago broker to purchase cheese in carlot quantities. This practice proves economical because the baker secures the services of an expert in locating suitable lots of cheese and eliminates the salary of a full-time buyer and the expense of his market visits. Many manufacturers employ brokers in the purchase of raw materials and supplies, especially under conditions where the goods come from numerous, scattered sources, and when there are important seasonal variations in supply.

Commissioners. In purchasing goods in foreign markets buyers are frequently under the disadvantage of a lack of knowledge of good sources of supply and are further handicapped by a lack of knowledge of the language. To assist such buyers, individuals known as commissioners or commissionaires are found in foreign markets. It is the function of the commissioner to bring the buyer into contact with proper vendors and to function as an interpreter. When the American buyer is not abroad, the commissioner keeps in communication with him, furnishing him with samples and information about goods. The commissioner represents the buyer and receives his compensation from him.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of each of the following terms:
   - *a*) marketing function
   - *b*) quantity buying
   - *c*) concentration of purchases
   - *d*) group buying
   - *e*) central buying
   - *f*) specification buying
   - *g*) resident buying offices
   - *h*) purchasing agents (two meanings)
   - *i*) commissioners
2. "Buying is merely a passive function—just the opposite of selling. If a firm does a good job of its own selling, buying will take care of itself." Discuss and evaluate.
3. "You get just what you pay for. In the long run, the greatest economy is obtained by following a policy of always buying the highest available quality." Discuss and evaluate.
4. Have the buying problems of ultimate consumers become *more* or *less* difficult in recent years? Explain.
5. The problems of the retailer and wholesaler have changed drastically in the last 20 or 30 years. Formerly it was customary and accounted good business to carry a great variety of lines of merchandise with high inventories in each. Why does not the average successful business of today do this?
6. Have the buying problems of retailers become more or less difficult in recent years? Does the presence of the wholesaler in the trade channel complicate or simplify the buying problems of retailers? In what respects

may the retailer rely upon the wholesaler to aid him in solving such problems?

7. How would factors relating to the choice of sources of supply vary in relative importance for the following types of buyers: (*a*) government purchasing agents, (*b*) industrial purchasing agents in medium-sized factories, and (*c*) small independent retailers?

8. What kinds of organizations are most likely to use group buying? Central buying? Specification buying? Compare the advantages of each of the forms of buying and indicate what they have in common and how they differ in respect to advantages? How can you explain what they have in common?

9. Henry Farmer is the owner-manager of a typical independent hardware store located in a medium-sized city. He has just been approached by representatives of a retailer-cooperative group that seeks to enlist him as a member. The group owns and operates a wholesale warehouse that supplies practically all the merchandise requirements of its 200 hardware store owners. If Henry joins the group, he would have to buy a share of stock and agree to buy all merchandise from it, except for a limited range of items which it does not carry (e.g., lawn and garden seeds). The wholesale organization employs no salesmen. Members make out their own order weekly from a catalog. The cooperative has a good reputation for merchandising, prices, and prompt and dependable delivery service. At present, Henry buys from four different wholesalers and from several long-line manufacturers. He is in good financial condition and could easily provide the capital for purchasing an ownership interest in the cooperative group. What factors should he consider in reaching a decision?

10. A purchasing agent for a fairly small manufacturing company must buy, among many other things, paper towels for use in various washrooms in the factory and office facilities of the company. Towels have been purchased from a local paper wholesaler in quantities of 10 cases, which is equivalent to about one month's supply. A salesman for a paper manufacturing company has just called on the purchasing agent and offered towels of comparable quality at a 10 per cent discount from the wholesaler's price, if purchased in quantities of 100 cases. Shipments would be made from the factory, which is at some 900 miles distance, and freight would be paid by the manufacturer. Evaluate this proposal.

11. You are merchandise manager for a large midwestern department store. For purposes of reviewing sources with your buyers, *explain* what would be the logical source (with regard to markets, types of sources, or even specific suppliers) for each of the following:

    a) Drapery material
    b) Carload of sugar for the soda fountains
    c) Men's suits
    d) Miscellaneous notions which are carried in small quantities to meet infrequent sales
    e) Miscellaneous drug items
    f) Hardware for a small hardware department
    g) Cotton textiles for the yard goods department
    h) Hosiery
    i) Furniture

12. The Smith Department Store enjoys a $20 million annual sales volume in a southern city. The president of the organization is exploring the possibilities of extensive group buying through an arrangement with its New York resident buyer. What is to be gained by this, and what are the shortcomings of such a venture? How are the buyers of the store likely to react? Explain.
13. "Goods well bought are half sold." Discuss this adage in the light of past and present-day conditions.

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THE SELLING FUNCTION: ADVERTISING

A major function for most business firms today is that of establishing and maintaining a market for their products and services. In the case of such simple business enterprises as roadside markets, ordinary display and the more elementary forms of personal selling are the only expression of this function. Many a manufacturer conducts elaborate and very costly campaigns designed to arouse or stimulate demand for his product or to divert it from a competitor. In each case the farmer or the manufacturer is engaged in carrying on one of the most essential marketing functions, that of demand creation[1] or selling. Retailers, wholesalers, and other middlemen are faced with similar selling problems. In a competitive, private enterprise economy, it is part of their task to create a demand both for the goods that they sell and the marketing services that they perform and certainly to divert such demand from competitors.

Modern Necessity for Sales Effort. During the domestic and handicraft stages of industrial development there was little need for the creation of demand. When production was in the home, such activities were unneces-

[1] Throughout this book the term "demand creation" is used in the rather loose, broad, and very general way that has become customary in all discussions of advertising and personal selling. For example, the word "demand" must not be interpreted to mean a stubborn insistence upon the product advertised, for seldom is it meant to be other than a mere recognition, a favorable impression, or a preference with respect to it. More important, the word "creation" must not be interpreted to mean as bringing into existence something which has not existed before, for usually it refers to the bringing into consciousness and action motivations that have been dormant or otherwise ineffective. Actually, then, instead of "creating demand" in the literal sense, what selling effort (including advertising) does is to arouse, stimulate, or direct a prospective buyer's conscious or dormant desire for want satisfaction that results in action with reference to a given product, service, or seller.

sary. Under the handicraft system customers came to the craftsman without special efforts on the part of the latter to attract trade. Shoemakers and barbers used their characteristic signs just as they do today and were content to attract patronage by the quality of their work, by their convenient location, or by virtue of their personality. The Industrial Revolution changed this situation to a considerable degree. Factories became common. In order to carry on factory production and to use the new power and new machinery successfully, it became necessary to operate on a large scale. Manufacturers were forced to look beyond the limits of their home communities for their markets. In order to sell in distant localities, some method of telling prospective buyers about their products had to be devised. Personal representatives were sent out, and crude forms of advertising were used occasionally. Sales activities thus became of some importance and took their place among the other functions of the early manufacturers.

Other factors helped in the development of sales activities. One of the most important was the series of inventions which made newspapers and magazines possible. A general increase in the level of intelligence of the masses paved the way for selling by the printed word and by other means of advertising. Improvements in transportation were a part of the Industrial Revolution and made it economical and feasible to distribute products of the early factories over a comparatively wide area. These forces combined to enable manufacturers to sell in wider and wider territories as time went on but, at the same time, made some form of demand creation an absolute necessity.

During this century there has been a great increase in the number and variety of products used by the average consumer. Articles which in the earlier days were regarded as luxuries or were nonexistent are now staples or necessities in the daily life of modern man. Inventions have greatly increased the number of articles used by the average person. Higher standards of living have made former luxuries commonplace. Thousands of manufacturers now compete for the patronage of masses of the common people. One result of this development has been the necessity of telling the average consumer about the various products available for his use.

The degree to which our economy is dependent upon aggressive selling effort has come more to the forefront of business and public thinking since the middle 1940's. Industrial research and technological advances have brought forth many new products and have also greatly expanded the nation's capacity for production. It is now rather widely accepted that the high level of prosperity characterizing the mid-1950's could not have been achieved in the absence of aggressive selling effort. Business executives, economists, and other social scientists have become more cognizant of the circumstance that an expanding consumption of goods and services, which is altogether necessary to support high levels of employment and per capita

income, can be achieved only in an economy in which consumers are stimulated to buy things which they might not buy for some time or not at all in the absence of vigorous selling effort.

Methods of Selling. Two principal methods are involved in the selling function: *advertising* and *personal selling*. Advertising is any *paid* form of *nonpersonal* presentation of goods, services, or ideas to a group by an identified sponsor. It involves the use of a large variety of media as diverse as are printed postcards from television. Personal selling, on the other hand, is the process of personally assisting and persuading a prospect to buy a commodity or service or to act upon an idea. It includes all oral presentations in conversation with one or more prospective buyers, either in their actual presence or by telephone. The presentation may be formal, in the nature of a carefully rehearsed sales talk, which is presented in substantially the same manner to all prospects, or it may be and usually is informal.

Certain other terms commonly used in the sales field, such as publicity and sales promotion, should be understood in this connection. *Publicity* is *any* form of commercially significant news items or editorial comment about products or institutions published in space or broadcast time that is *not paid* for by the sponsor, although the term is sometimes used in a broader sense to include advertising. *Sales promotion* includes those selling activities that supplement both advertising and personal selling, coordinate them, and render them more effective. It includes sampling, displays, demonstrations, and various kinds of nonrecurrent selling effort.

Relation of Advertising to Personal Selling. Advertising and personal selling are not as a rule in competition but rather supplement each other. A marked characteristic of personal selling is that the message is usually delivered to a definite prospect. Advertising, except for direct mail, on the other hand, must appeal to the mass mind. It is directed to the average individual and is therefore impersonal. Moreover, personal salesmanship is adaptable. The message can be adjusted to the individual prospect and appeals can be selected which are of most importance to him. The speed of delivery and the language of the sales argument can be adjusted to the prospect's training or general intelligence. Objections can be met as they arise, and thus effective demand can be created.

Advertising is used, as a rule, to assist the salesman. It aims to give preliminary information and to break down resistance which might operate to prevent the later, effective delivery of a sales message. Advertisements in trade magazines can be used, e.g., to tell the story of a certain type of gear cutter and to suggest that many companies have used such machines with success. Purchasing agents and mechanical engineers are much more apt to give a careful hearing to the salesman for a machine of this kind when he calls than would be the case if they knew nothing about the machine

in advance of the call. Thousands of people may tentatively decide to purchase a certain kind of automobile because of the manufacturer's advertising, but as a rule it is not until after further selling effort by the dealer's salesman that a purchase is actually made.

Although commonly supplementary to each other, either of the two methods of selling may be used exclusively. Many unbranded and unadvertised raw materials and some manufactured commodities are sold without advertising. Many articles, including some forms of jewelry and many novelties, are sold by mail through advertising and without any personal salesmanship. The large, general mail order houses are another example of selling by advertisements and catalogs without personal solicitation. The proportion of total goods sold by advertising alone is, however, exceedingly small. Furthermore, modern distribution is normally based on the use of both methods, neither one entirely supplanting the other.

Advertising as a Business Activity

Ultimate consumers in almost all walks of life are continually exposed to advertising in one form or another. Whatever the form, the advertiser's message generally appears to the consumer as a simple presentation. Obscured behind the scenes, however, are a score of important business decisions that have a bearing upon the impact made upon the consumer. Various types of advertising must be considered for different purposes; ideas are conceived and advertisements are prepared as a result of careful plans made well in advance of publication; media are selected to convey the prepared message to the prospective recipients; and, for some or all of these decisions, a special institution known as the advertising agency is often employed.

Types of Advertising. There are many types of advertising and these may be classified in a number of different ways. Furthermore, the various types or classes of advertising commonly recognized are not mutually exclusive but are often different ways of looking at the same thing. For example, advertising may be classified as *institutional* or *merchandise,* depending upon whether it is aimed primarily at establishing a favorable attitude toward the advertiser or at the development of demand for a given product. It may be classified, on the basis of the advertiser's status, into *manufacturers', wholesalers', retailers',* or *cooperative* advertising. Again, advertising may be classified as *consumer, trade, professional,* or *industrial,* in terms of the audience to which it is directed and the aim to be achieved. Finally, it may also be classified on the basis of the principal appeal used and whether the purpose of such an appeal is to arouse and direct demand toward a specific product or to a given general class of products.

Advertising Media. The vehicle or carrier through which an advertising message is conveyed to its intended audience is known as an advertising medium. The major classes of media and the relative importance of each are indicated by the following data for traceable advertising expenditures in 1955:[2]

Medium	*Advertising Expenditures* *Amount (millions)*	*Per Cent of Total*
Newspapers	$3,070	34.0
Direct mail	1,270	14.1
Television	1,005	11.1
Magazines	724	8.0
Radio	545	6.0
Business papers	415	4.6
Outdoor advertising	193	2.1
Farm publications	33	0.4
Miscellaneous	1,774	19.7
Total	$9,029	100.0

The foregoing data include not only the time or space cost for media, but also budgeted charges of a related character such as art or layout work in space publications or talent costs for sponsored broadcast and televised programs. The prominence of newspapers is explained by the fact that the bulk of local retail store advertising is carried in this medium. Each of the major classes or types of media may be further subdivided; magazines, for example, can be divided into weeklies and monthlies, or into men's, women's, children's, and general.

From the standpoint of the advertiser, the different types of media may be complementary or competitive. Each type has its value, is favored under given conditions, and is subject to certain limitations. Several types are often used simultaneously in well-rounded advertising campaigns, each supplementing the others. This entire matter is usually given detailed treatment in a course devoted to the Principles of Advertising as well as in more advanced courses in that specialized area of marketing.

Product Advertising by Manufacturers. While the details of manufacturers' advertising programs vary with the kind of product and character of the company, a common function is that of *building acceptance or preference for the advertised product,* and a common pattern of managerial decisions is followed.

First, the advertiser must be certain that the product to be promoted actually satisfies some basic need; otherwise, no amount of advertising can win acceptance for the product. Second, it is necessary to discover the uses or applications of the product, and confine the advertised uses to reasonable ones that satisfy important common needs. Third is the determination of

[2] "Advertisers' Guide tc Marketing for 1957," *Printers' Ink,* August 24, 1956, pp. 40-41.

distinctive characteristics of the product to be used as selling appeals. For advertising to be successful over a period of time, these should be real and recognizable distinctions. Most manufacturers' advertising is characterized by an attempt to give the product a personality or identity which will make it stand out competitively. This requires close coordination between the planning of advertising and package or label design.

Other major management problems relate to the determination of the market for the product, whether general or highly restricted to a segment of the total market; the selection of media which will reach the consumers of the product and possibly also the trade; and the determination of an advertising appropriation that will be adequate to accomplish the objective of the program. The appropriation is likely to be large per unit of product if an item is in the introductory stage of development and, hence, is not well known to consumers or distributors; it is likely to be large in total amount, but small per unit of product, if the item is in the competitive stage and similar products are being mass-produced and mass-distributed by a number of companies.

Merchandise Advertising by Retailers. Retailers' merchandise advertising differs from that of manufacturers' in objective. Whereas the manufacturer usually seeks to build acceptance or preference for his brand of product, the retailer is concerned primarily with *building good will or patronage for his particular store.* Except where exclusive agencies are common, as in the automobile field, retailers' advertisements are characterized more by variety and assortments of merchandise rather than by individual items. Stress is placed upon patronage motives such as price, selection, location of stores, or services. In retail advertising there is also more of an attempt *to provoke immediate buying reaction* than is the case with manufacturers' advertising where a long program may be planned to build or sustain consumer acceptance or preference. This accounts for very marked concentrations of retail advertising at times when consumer buying urges are most active, as evidenced by heavy grocery advertising on Thursdays in anticipation of week-end shopping, or unusual quantities of department store advertising at Christmas, Easter, school-opening time, and on other occasions when consumers are most likely to respond to specific advertising appeals.

The Advertising Agency. The growth of advertising has been associated with the development of a specialized type of institution known as the advertising agency. The first advertising agents began business about the middle of the nineteenth century and were originally space brokers for media. At that time newspapers were springing up all over the country. Their editors were anxious to obtain revenue from advertising but had no contacts with out-of-town advertisers. The first agents were men who recognized this situation as an opportunity for rendering an economic service. They purchased

or contracted for "white space" from the media and contacted advertisers in distant areas, selling the space in units suited to the requirements of the advertisers. Gradually the agents began to give advice and assistance to advertisers who were seeking specialized counsel in the preparation of their copy. In time the agents developed new methods and techniques and offered new services. Eventually the advertisers rather than the media became the "clients" of the agents.

Today the advertising agency is a service organization composed of advertising specialists, and it shares the responsibility for advertising activities with the advertising departments of clients. It is believed that advertising agencies now assist in the creation and direction of more than 90 per cent of all national advertising, more than one-half of sectional advertising, and a considerable amount of local advertising. Between 1948 and 1954, the number of advertising agency establishments increased from 3,279 to 5,077. A very large per cent of the total advertising agency business, however, is accounted for by a limited number of large agencies, most of which are located in New York City.

Services of Agencies. The principal services of modern advertising agencies consist of planning, preparation, and placement of advertising. Planning requires a thorough knowledge of markets, products, distribution channels, and marketing policies. This often involves marketing research, which is carried on by or for the agency. Preparation includes developing a central idea or theme, production of advertisements, production or purchase of art work and printing, hiring radio and television talent and supervising or producing entertainment programs, writing radio commercials, and preparing audio-video television commercials. Placement involves selection of media; preparation of advertising schedules; purchase of broadcast time or publication space; shipment of plates, copy, and instructions to media; preparation and mailing of direct advertising; checking publications or stations to insure that advertisements were run or broadcast properly; and billing clients for all expenses incurred in connection with the advertising program. In addition to these basic services, many agencies engage in more extensive activities. Some of the larger and some of the highly specialized agencies provide a marketing counseling service and go so far as to advise a client on broad management policies for his business. They assist in product development and package design; secure patents and copyrights; prepare point-of-sale promotional aids for the client's sales force; carry on public relations and publicity work; arrange and plan demonstrations and contests; and prepare training material for dealers' and jobbers' salesmen. In fact, there is almost no type of service related to marketing which is not provided at least by some of the agencies.

Why Agencies Are Used. Even the largest advertisers, who maintain elaborate advertising departments and who could probably handle large-scale campaigns economically, give their accounts to some reputable advertising agency for several reasons. First, the agency is independent of the advertiser and has an outside objective viewpoint which it can bring to bear on important decisions. Second, the agency has broad experience which results from its work with a number of clients having different products, selling in various markets, using various channels of distribution, and employing numerous types of media. Third, it must do a satisfactory job in order to hold the account. It is constantly alert to opportunities because it realizes that the advertiser can change agencies easily If an advertiser developed an advertising department capable of performing all agency services, such a department would be part of the organization and could not be disposed of easily. Fourth, the agency may spread the cost of certain technical services over a number of accounts. The payroll costs of advertising production specialists and marketing research experts is less than it would be if each advertiser had a staff comparable in skills to that of the agency. A fifth and most important reason is that all or a large part of the agency's service may not cost the advertiser anything. This is true because agencies obtain a substantial part of their revenue from media commissions which are not available to advertisers who buy space or time direct from the media.

Agency Compensation. The compensation plan in general use in the advertising agency system is a carryover from the early days when the principal function of an agency was selling space for media. Most agencies today still obtain the greater part of their remuneration from the media, based upon the amount of space or time purchased for clients. The agency purchases publication space or broadcast time direct from the media. With only minor exceptions, it receives a discount usually amounting to 15 per cent of the list price of the space or time purchased. For example, if a full page of space in a popular consumer magazine is listed at $10,000 for one issue for a black-and-white advertisement, the recognized agency is billed for $10,000 less a 15 per cent discount, or $8,500. The agency bills its clients for a space cost of $10,000 and retains the $1,500 to defray the expense of preparing the copy, placing, and checking the advertisement. If the advertiser did not use the agency, it would pay the magazine the full price of $10,000 and would, furthermore, have to incur the expenses of preparing and placing the advertisement.

Agency commissions from media are often supplemented by service fees paid by clients. The commission is intended to cover the service cost of preparing and placing advertising. It does not provide payment for extensive marketing research work, elaborate art work or engravings prepared outside the agency, talent for radio or television entertainment, preparation of spe-

cial signs or dealer-helps, or other special services rendered or procured by the agency for the client. For such services it is customary for the agency to levy special charges based on the cost of the services plus some percentage fee agreed upon at the time the relationship is established.

The agency method of commission compensation has often been criticized as illogical, inasmuch as the services of advertising agents are rendered primarily to advertisers rather than to media who pay the commissions. It has also been criticized because the traditional pattern of commission payments became rigidly institutionalized. Various trade associations of advertising agencies and of advertising media have established criteria to be met by business firms in order for them to be recognized as accredited agencies entitled to receive such commissions. Also, it has been considered an unethical trade practice for agencies to split media commissions or to rebate any part of them to advertiser clients.

The whole agency compensation pattern was called into question in the 1950's when the U. S. Department of Justice brought proceedings against various such associations under the Sherman Antitrust Act. Early in 1956, a leading association of advertising agencies and several media associations entered into consent decrees which, among other things, prohibited practices or agreements "fixing, establishing or stabilizing agency commissions or attempting to do so" or "requiring, urging or advising any advertising agency to refrain from rebating or splitting agency commissions."[3] These consent decrees provoked a number of trade press articles containing speculations about the future of agency compensation methods.[4] While there is much difference of opinion, many informed persons believe that the pattern will eventually change, evolving gradually from dominant emphasis upon media commissions to major reliance upon charges for the actual costs of rendering professional services to clients.

Agency commissions from media have not been an important factor in local or retail advertising. Newspapers and radio and television stations usually have direct contact with local advertisers. Partly because of the news value of local advertisements and partly because the large portion of revenue is obtained locally, newspapers and other local media usually have lower space or time rates for local than for nonlocal advertisers. Agency discounts do not apply to these lower local rates. This has restricted the use of ad-

[3] *United States v. American Association of Advertising Agencies, Inc.; The American Newspaper Publishers Association, Incorporated; Publishers Association of New York City; Associated Business Publications, Inc.; Periodical Publishers Association of America; and Agricultural Publishers Association.* United States District Court for the Southern District of New York. Civil action No. 100–309, dated February 1, 1956.

[4] See, for example, "Future of Agency-Client Relations Probed by A.N.A.," *Printers' Ink,* March 23, 1956, pp. 24 ff.; "Will Agency Commission System Change?", *Printers' Ink,* May 4, 1956, pp. 21–22; "Agency Head Stoutly Backs 15% Commission," *Printers' Ink,* June 8, 1956, p. 24; "Agency Compensation As Covered by Young and Haase Reports," *Printers' Ink,* June 29, 1956, pp. 42–53.

vertising agencies in local advertising, because they must make a specific charge for the total value of the service rendered to local clients.

Economic and Social Aspects of Advertising

In the preceding pages advertising has been discussed as an important activity, assumed to be essential to the preponderant majority of business concerns. The broader economic and social aspects of advertising are, however, a matter about which there is a considerable difference of opinion. From these viewpoints, advertising has its advocates and its critics. A proper evaluation of the position of proponents and critics may be made, however, only after examination of the services of advertising to society as a whole, consideration of the important criticisms directed toward it, and a review of the social controls imposed upon its use.

Contributions and Services of Advertising. The place of advertising in our life is better understood if certain facts relating to the service of advertising to society as a whole are examined objectively. In the early part of this chapter, it was suggested that advertising did not become important until large-scale production made certain demand-creation activities necessary. Successful advertising campaigns have in turn *accelerated the movement toward large-scale production* by many manufacturers. As a rule, increase in the scale of production is accompanied by decreasing costs per unit of output. There are hundreds of examples of reduction of the total cost of production and distribution through successful advertising. It is equally true that advertising and a liberal use of personal selling efforts have been made necessary in order to find a large market in which to sell the increased output resulting from quantity-production methods. *Thus advertising is both a cause and effect of large-scale activity*, with emphasis probably on the latter. In either case, the result is the same. Decreased cost of production in many cases offsets wholly or in part the cost of demand-creation activities.

Another important service of advertising lies in its *beneficial effect on the standard of living*. One measure of a nation's material progress is a cross section of the wants of the common people. In other words, advancing civilization is accompanied by increases in the quantity and variety of wants and the means of satisfying them. Advertising has done much to encourage better homes, architecturally, mechanically, and functionally. Dozens of articles are in use in the average home of today as the result of demand stimulation by advertising. Vacuum sweepers, electric refrigerators, mechanical dishwashers, and modern floor and wall coverings are illustrations. Many advertised articles help to make the modern diet more nutritious and varied than formerly.

Since advertising facilitates the profitable exploration and development of markets for new or improved products and uses, *it has tended greatly to encourage innovation and technology.* There is no doubt but that much of the technological progress in the electronic, chemical, and automotive fields recorded in modern times can be attributed to the development of potential demands for the products and uses thus made possible. This is a contribution of first-rank importance that must not be overlooked in any critical study of advertising.

The *educational effect of advertising* is likewise important, both directly and indirectly. It is probable that advertisements of dental creams have done more to preserve the teeth of the nation than has the personal advice of thousands of dentists. Correspondence courses which have been of great aid to many people are made possible largely because of advertising. Advertising, insofar as it is truthful, educates by making known the facts about hundreds of articles which might be otherwise unknown or unaccepted by the average buyer. The *indirect effect of advertising upon education* is undoubtedly even more potent. No newspapers or magazines could be sold at prices that would make them accessible to the masses of our people in the absence of advertising which largely subsidizes them. The many radio and television programs of both an entertaining and educational nature would be virtually impossible without the sponsorship by advertisers. Radio exists almost entirely on its income from advertising sponsors. About two-thirds to three-fourths of the average income of newspapers and magazines comes from advertising.

Constructive advertising *lessens to a great degree the necessity for buying ability.* In the days of the more simple life it was possible for buyers to be judges of the quality of the articles they purchased, since these were comparatively few in number. It is now almost impossible for the average buyer to judge with any certainty the quality of the hundreds of articles he buys. But fortunately the use of brands, which is an essential for most advertising, makes it possible to rely on the standard quality of such merchandise, and identification enables one to avoid repurchase of unsatisfactory brands.

Criticisms of Advertising. There are certain considerations that tend in part, at least, to offset the social value of the services of advertising. Many criticisms have been made, and some of these are partially sound. Most of the criticisms are, however, the result of misunderstandings about the true economic function of advertising or stem from a failure to view advertising in a proper social perspective. The most commonly voiced and perhaps also the most important of these criticisms are examined in the following paragraphs.

"Too Costly." A common criticism is that the cost of advertising is too high and that such high cost adds to the price of the advertised product. This

criticism grows out of the rather common knowledge that certain large advertisers spend millions of dollars for advertising in a single year.[5] It is also known to many that the space cost for a single full-page advertisement in a number of the more popular weekly magazines is in excess of $10,000; that 15 minutes of evening broadcast time on our national radio networks costs several thousand dollars; and that the cost to produce and broadcast several of the more elaborate television programs has exceeded $100,000 for a single performance. These amounts appear staggering to the average person who forgets that expenditures for advertising are significant only when expressed in relation to some meaningful standard of comparison.

One way of judging the magnitude of advertising expenditures is in relation to total personal consumption expenditures. As shown in Table 20, advertising expenditures in 1955 amounted to over $9 billion, but this was only 3.5 per cent of all consumer expenditures for goods and services. Over a long period of years, advertising costs of about 3 per cent to 4 per cent of consumption expenditures have been typical. This basis of comparison, however, overstates the relative importance of advertising costs. Much advertising is devoted to industrial goods and services and some to goods sold

TABLE 20

TRACEABLE[a] ADVERTISING EXPENDITURES IN AMOUNT AND AS PER CENT OF GROSS NATIONAL PRODUCT AND PERSONAL CONSUMPTION EXPENDITURES—UNITED STATES: SELECTED YEARS, 1929–1955

	Amount (billions)			Advertising Expenditures as Per Cent of:	
Year	Advertising Expenditures	Gross National Product	Personal Consumption Expenditures	Gross National Product	Personal Consumption Expenditures
1929	$3 4	$104.4	$ 79.0	3.3	4.3
1934	1 6	65.0	51.9	2.5	3.1
1939	2.0	91 1	67.6	2.2	2.9
1944	2.7	211.4	109.8	1.3	2.5
1949	5.2	257.3	180.6	2.0	2.9
1954	8.2	360 5	236.5	2.3	3.5
1955	9 0	390.9	254 0	2.3	3.5

[a] Traceable advertising costs include all expenditures for advertising that can be measured from one year to another They include the space and time cost for all forms of media and related budgeted items as for production of advertising and talent on sponsored programs They do not include nontraceable costs such as the payroll time of those working with the advertising function in manufacturing and marketing establishments

Source Traceable Advertising Expenditures from "Advertisers' Guide to Marketing for 1957," *Printers' Ink*, August 24, 1956, pp 68-69 Gross National Product and Personal Consumption Expenditures from Table 3

[5] In 1955, 259 different companies spent over $1,000,000 each for advertising. For a list of these companies, with advertising expenditures for each by type of media, see "Advertisers' Guide to Marketing for 1957," *Printers' Ink*, August 24, 1956, pp. 77 ff.

primarily to government. It is, therefore, more meaningful to compare the costs of advertising to the gross national product. Over a period of years, this basis reveals that advertising costs of only somewhat more than 2 per cent is the common situation. Even this, however, is not a correct gauge, because the advertising cost thus calculated is not related to the volume of business transacted. In such terms it would no doubt be less than 1 per cent.

Another important approach to understanding advertising costs is in terms of units of products sold. The public is undoubtedly as conscious of large advertising expenses in the cigarette field as in any other industry. Yet the great amounts expended for advertising shrink into insignificance when compared with the tremendous number of units of product sold by the industry. Experience varies from one tobacco manufacturing company to another. Advertising expense has been only about one-fifth of a cent per package for one firm with the lowest advertising costs and only about one-half cent per package for another with the highest costs in the industry. This is, of course, only one example. Illustrations in other fields would reveal different results. Advertising costs have been relatively high in comparison with the final retail value of soaps, cosmetics, and drugs. With these exceptions, however, advertising costs of most manufacturing companies are quite low when measured per unit of product sold or in relation to total sales volume involved.

The costs of advertising can also be compared with costs incurred for personal selling effort. Advertising expenses of most retail stores are only about 1 or 2 per cent of sales volume, the most notable exceptions being department stores, departmentized specialty stores, and furniture stores where advertising costs often amount to as much as 3 to 5 per cent of sales. In practically all cases this is substantially less than the expense of personal selling incurred by the same stores, and in the great majority of instances advertising costs are only a small fraction of total selling expense. Among manufacturers, advertising costs of about 1 to 3 per cent of sales volume are the common experience. While there are some exceptions to such low advertising costs, as explained in the preceding paragraph, the cost of advertising is usually low in comparison to the expense of maintaining a personal selling organization in the field. If less were spent for advertising, it would be necessary for most merchants and manufacturers to exert additional personal selling effort in order to maintain their position, and *total selling costs* would undoubtedly be considerably higher. The experience of the business community has been that advertising, when properly performed, is a relatively cheap form of selling effort and that it makes personal selling more efficient, since it paves the way for the salesman.

In the last analysis, the question of how much is spent for advertising is not particularly significant. It is much more important to inquire about

how much we get for what we spend. A student of the subject should be more interested in the *values that are added by advertising* in relation to expenditures therefor than in costs per se. Such considerations provide the only truly meaningful appraisal of the significance of advertising expenditures in the economy.

Emphasizes Minor Differences. Another criticism is that advertising has tended to develop and emphasize minor differences in the construction or formulae of advertised goods in order to have "something to advertise." It is much easier to call forth additional effective demand for a product if it is new or appears to be so than when it is just another brand of the same general type as dozens already on the market. For example, it is probably true that there are many brands of advertised toothpaste which are not essentially different and which perform the same functions as previously established brands. It has, therefore, been necessary to emphasize minor chemical differences or new features in the packages which are not always worth while. The effect of this is, in part, to reduce the scale of operations of the factories already producing toothpaste with the possibility of increased production costs. To the extent that this is true, the featuring of new brands, not essentially better than those already on the market, may be economically and consequently socially unjustifiable.

But advertising of new brands does not necessarily divert demand from older manufacturers. In many cases additional advertising has the effect of increasing the total consumption of the article under consideration. This additional consumption may or may not occur at the expense of other articles formerly purchased. When a new make of air conditioning equipment for the home is placed on the market, its advertising will no doubt, at the present stage of development, increase the total sale of such equipment. In part it will divert to the new manufacturer sales which might otherwise have gone to existing suppliers. The effect may be to divert funds to the purchase of air conditioning equipment which might have gone for clothing, alcoholic beverages, entertainment, insurance, or to savings accounts. In such a case, the social service of advertising must be judged by the relative social value of the alternative purchases.

This criticism does not apply merely to new brands but to new models of established brands as well. Manufacturers of automobiles, major electrical appliances, and other durable consumer goods are often criticized for making minor changes in styling or design which, it is claimed, have no relationship to the satisfaction-yielding potential of the product, merely for the purpose of justifying large-scale periodic advertising campaigns. Certainly it is quite frequently the case that one model of a given make of automobile is not greatly different from the preceding model. If the annual models of any

make of car are compared over a long period of years, however, a much different conclusion is reached. Such a comparison brings into evidence a continuous parade of product improvement. The automobile of the early 1920's differs from the car of today by the sum of hundreds of relatively minor year-to-year advertised differences. The opportunity of making known to the public any product improvement through the force of advertising provides manufacturers with a strong incentive to take advantage of every possibility of increasing consumer satisfactions.

"Purely Competitive." A third and somewhat related criticism is that advertising is purely competitive and that the net result is to divert demand from one good product to another which is equally good but not superior. There can be little question as to the truth of this assertion insofar as a large proportion of manufacturers' advertising is concerned. The potential market demand determines to a considerable degree whether or not advertising has the criticized effect. In the foregoing illustration concerning air conditioning, it was assumed that the potential demand for air conditioning equipment is very great and that a part of the effect of the advertising was to develop additional demand for the product. Had the illustration referred to bread, the effect would have been vastly different. Advertising of brands of bread has relatively little effect in increasing the demand for bread as a whole, for such demand is comparatively stable. Rather, its effect is largely to divert demand from one baker to another. If the advertising baker's bread is no better than that baked by competitors and if it is assumed that bakeries as a whole are already operating at a technological and economic optimum, then the cost of the campaign may be considered an economic waste or a premium paid by consumers to maintain competition.

To be sure, much advertising is primarily of this nature. The selective appeals featured in competitive advertising have the effect of strengthening or protecting the market position of an individual concern rather than of increasing the total demand for a given class or type of product, although the latter effect is frequently a significant by-product. This is, however, one of the characteristics of a competitive society. Most students of the problem recognize that much competitive effort could be eliminated were it desirable to establish a more paternalistic or dictatorial form of government. Under such circumstances it might be possible to control and even to eliminate advertising that is purely competitive. But such control would be at the expense of free competition, and freedom of competition is generally believed to be so desirable as to justify some of its inherent wastes as a necessary price for its maintenance. Finally, in a dynamic society one cannot be sure that a technological and economic optimum will long remain so; hence competitive advertising may not be "purely" competitive so long as the competitors do not continually operate at the optimum level.

"Misleading and False." An often-heard criticism of advertising is that many advertisements are misleading or definitely false. There is no doubt that this is true. Numerous advertisers have cleverly created a misleading impression even though every statement in their message, when separately considered, is literally truthful; others have quoted carefully selected findings of authoritative research studies out of context and in such a way that the quotations are construed as a product indorsement. Still others have artfully contrived to divert the reader's attention from the true nature of the terms of an offer by emphasizing headlines which give a false impression; additional advertisers have devised sensational tests which make a convincing sales argument but which have no relationship to the consumer's satisfaction from the use of the article. It is nevertheless significant that the Federal Trade Commission in its examination of hundreds of thousands of magazine, newspaper, and radio advertisements finds that only a very small percentage contains statements that appear to be misleading or false to a degree which justifies possible action by the Commission. The work of the Commission has been influential in improving the general confidence in advertising. Other controls discussed later in this chapter have also contributed to the same end.

"Inefficiency." Another alleged weakness of advertising as conducted at present in this country is its inefficiency. To be sure, some advertising is inefficient, and doubtless all advertising is less efficient than it could be. Advertising is a relatively new art. It is not yet a science, although scientific methods of procedure are being rapidly developed. Many valuable methods and principles have been and are being evolved as the result of the contributions of psychologists and sociologists. Such study has led to improved typography, more appealing copy, and improved layout. The more widespread practice of testing trial advertisements has eliminated considerable waste resulting from poorly conceived advertising programs. Media are now selected with more skill as a result of extensive research regarding characteristics of the circulation or audience of specific and general classes of media. Motivation research has yielded a better knowledge of consumer buying behavior, and has enabled advertisers to harmonize selling appeals with buying motives, with the effect of minimizing waste or inefficiency in the use of advertising appropriations. Other improvements in technique are constantly being developed which will no doubt lessen some of the crudities common in the past.

Control of Advertising. Popular credence in the printed word endows advertising with great potential power. At the same time, advertising is more or less centralized and is, therefore, susceptible to control. These factors no doubt explain in part the widespread control of advertising on the one hand and the complete absence, with but rare exceptions, of control over

the broader area of personal selling on the other. Control of advertising to date had been directed principally to the elimination of falsehood and fraud and the prevention of advertising of harmful products. More recently, partly in response to consumer pressure, attempts have been made to eliminate or minimize "bad taste" in advertising and to make advertising more informative and therefore more useful in making choices. Efforts at these various controls have been shared by many types of agencies and organizations.

Federal Trade Commission and Advertising. Foremost in the control of advertising is the Federal Trade Commission which was created in 1914 by the Federal Trade Commission Act and was charged, among other things, with the responsibility of determining and preventing unfair methods of competition. One form of unfair competition is misleading advertising intended to deceive the public to the detriment or injury of competitors. The power of the Commission was greatly expanded by the passage of the Wheeler-Lea Act in 1938. This law amended the original Federal Trade Commission Act in three important respects. First, it broadened the Commission's jurisdiction to include practices that injure the public but which may not involve or injure a competitor. Prior to this amendment, action could be brought only upon complaint of a competitor who was presumably injured by an allegedly unfair practice. Now, the Commission may take action of its own accord if public injury can be shown.

The second major change pertained to the enforcement of orders issued by the Commission. The process of enforcement was regularized and shortened by making cease and desist orders of the Commission effective after 60 days unless appeals are made to the federal district courts. Furthermore, it was provided that the Commission may bring action in the federal district courts in the case of violations of such orders, and substantial penalties of $5,000 were provided for each proved violation. It has been claimed that this penalty is not sufficiently severe because a violation may involve a considerable period of time. Some unethical advertisers doing a large volume of business found that such an amount is a small price to pay for the privilege of violation. For this reason, it has been advocated that the penalty be increased or made more severe so that a fine of $5,000 or more may be imposed for *each day* of violation.

The most important of the three principal changes made by the Wheeler-Lea Act is that which pertains to the *advertising other than labeling of foods and drugs.*[6] It definitely prohibits false advertising of food, drugs, cosmetics, and therapeutic devices. Certain infractions involving these items are rendered criminal when injurious to health or when involving intent to deceive

[6] Special forms of control over the labeling of food and drugs are explained in a following section.

or defraud, and are punishable by both fine and imprisonment. Temporary injunctions are provided to stop these practices pending issuance of a complaint and determination of the charges. The law also permits factory inspections and forces submittal of these commodities, when required, for testing purposes; if found harmful, their sale may be prohibited.

One of the effects of this law has been greater confidence in advertising by virtue of the protection afforded. Another result is greater emphasis on specific and more informative statements in advertisements. A third result has been a re-examination of products for characteristics that could be advertised under the law. This has led to research and product improvement.

In addition to its broad powers under the Wheeler-Lea Act, the Federal Trade Commission also has authority with respect to the sale, advertising, labeling or branding of certain individual commodities for which specific legislation has been enacted. The Wool Products Labeling Act of 1939 prohibits the misbranding of wool products by requiring that labels indicate the percentage of wool, reprocessed wool, and re-used wool contained in the product. The Fur Products Labeling Act, enacted in 1951, prohibits the false advertising or labeling of furs or fur products. Advertisements or labels must show the actual name or names of animals that produced the fur; that the fur is "used" if such is the case; and whether the product is bleached, dyed, or artificially colored in any way if such is the fact. The Flammable Fabrics Act, enacted in 1953, contains various technical prohibitions relating to the sale of articles of wearing apparel which are so highly flammable as to be dangerous when worn by individuals. Conviction under any of these acts is a misdemeanor, punishable by fines up to $5,000, or imprisonment not to exceed one year, or both.

Control by Other Federal Agencies. A number of other federal agencies have some control over advertising. One of great importance is the Pure Food and Drug Administration which operates under the authority of the Food, Drug and Cosmetic Act of 1938, which was an amendment to the Pure Food and Drug Act of 1906. Under the newer law, cosmetics and therapeutic devices were brought under control in addition to food and drugs; misbranding and misleading advertising of the specified products are banned; seizure of adulterated or contaminated foods is permitted; labels must warn of habit-forming drugs; factory inspections are permitted; and no drug can be placed on the market until after it has been tested to determine whether it is harmful. The various prohibitions may be enforced by injunction. Labeling must include the address of the manufacturer, packer, or distributor as well as facts concerning the quantity of the contents, major ingredients, and warnings against misuse of drugs. The Pure Food and Drug Administration works closely with the Federal Trade Commission. With respect to the selling function, the former agency is concerned prima-

rily with packaging and branding. Although it watches for deceptive advertising, it usually hands over questionable cases of advertising to the Federal Trade Commission for action.

The Alcohol and Tax Division of the Treasury Department exercises powerful control over the advertising of alcoholic products. Under federal licensing regulations, this agency may require approval of all advertising and labeling of intoxicating beverages. It is very strict in the regulation of misleading advertising and has definite requirements as to the use of names for beverages and specification of exact age, type, and alcoholic content. The Post Office Department also exerts some control. Federal laws forbid the use of the mails for fraudulent purposes. While cases are relatively rare, there have been instances where the use of the mails has been forbidden to organizations that cooperated in fraudulent advertising.

State Control of Advertising. A considerable degree of control is exercised over advertising in intrastate commerce. This has become effective through the widespread enactment of the so-called *Printers' Ink* Model Statute which was drawn up by the advertising trade publication of that name in 1911. The purpose of this legislation was to extend the "Truth in Advertising" movement to trade not susceptible to control by federal legislation. It aims, in general, at preventing in an advertisement "any assertion, representation or statement of fact which is untrue, deceptive, or misleading," by declaring such a statement a misdemeanor. This law has been enacted in 26 states and the District of Columbia, and 17 additional states have enacted adaptations of it. Only five states have no law of this kind.[7]

Control by the Business Community. Also of great influence is voluntary control of advertising by the business community itself. Better Business Bureaus were established primarily for the purpose of promoting more "truthful" local advertising, especially in the retail field and in financial advertising. Operating in the principal cities, their influence in controlling local unfair advertising practices has been salutary. Newspapers and magazines often refuse to accept certain types of advertisements, exclude certain products from their pages, and otherwise censor all advertising submitted for insertion. Following along similar lines, though much less extensively and perhaps less effectively, broadcasting companies have attempted similar controls. The efforts of certain trade and professional associations, particularly those designed to set standards for or to censor advertisements before they are printed or stated over the airways, have also been exceedingly helpful. Finally, there are several important associations of advertising agencies, advertisers, and advertising media which have played a leading part in efforts to make advertising more useful and to place it on a higher

[7] States not having such a law in 1955 are Arkansas, Delaware, Georgia, Mississippi, and New Mexico.

ethical plane. This has been accomplished through standards of ethical practice to which the members of the various associations have pledged themselves.

Questions and Problems

1. Define or briefly explain the meaning of each of the following terms:
   a) advertising
   b) publicity
   c) sales promotion
   d) personal selling
   e) advertising medium
   f) advertising agency
   g) advertising agency commission
   h) institutional advertising
   i) merchandise advertising
2. Can advertising really create a demand for a product? Explain.
3. Contrast the merchandise advertising of manufacturers and of retailers in purpose and nature.
4. How does the large advertising agency of today differ from the early advertising agents in this country? How are advertising agencies compensated for their services? Is such a plan of compensation logical or desirable in terms of modern conditions? Explain.
5. A critic of our marketing system advised the elimination of all selling and advertising. He queried: "Why not let people *buy?* Why *sell* things to them?"
   a) Is it possible to carry out the critic's advice?
   b) Assuming the possibility, is it desirable to do so from the standpoint of the seller, the buyer, and society at large? Explain.
6. Is advertising a costly selling device? Explain.
7. What are the constructive forces in advertising that make it socially desirable?
8. Who pays the cost of advertising? In this connection, how does advertising affect prices paid by consumers for the goods which they purchase? Explore all possibilities.
9. Evaluate each of the following statements:
   a) "Advertising costs the consumer millions of dollars every year. If advertising were eliminated, prices could be reduced, and everybody would be better off."
   b) "Most advertising is a social waste because it merely diverts demand from one competitor to another."
   c) "Advertising is of no value to the consumer, because most of it consists of large claims for very minute differences between similar products."
10. Who is injured by untruthfulness in advertising? Explain.
11. In what way or ways is each of the following concerned with advertising:
    a) Federal Trade Commission
    b) Food and Drug Administration
    c) U.S. Post Office Department
    d) Wool Products Labeling Act
    e) Wheeler-Lea Act
    f) Fur Products Labeling Act
    g) U.S. Alcohol and Tax Division
    h) Printers' Ink Model Statute
    i) Better Business Bureaus

12. What does society gain and what may it stand to lose by having a large portion of our radio, television, and newspaper costs paid for by advertisers? Do you favor the continuation of such a practice? Explain.

13. What problems would you encounter if you attempted to measure the effectiveness of advertising in increasing the demand for a product?

14. How can one explain the relatively extensive controls of advertising on the one hand and the nonexistence of similar controls of personal selling on the other?

15. If you were to start a new enterprise for the manufacture of a product for consumer use, would you begin with an advertising program first, or would you start with traveling salesmen and then follow up with advertising? Explain.

16. A manufacturer of a new washing powder is attempting to work out a satisfactory method for distributing his product. It is decided that wholesalers are best equipped to do the job. There is, however, still the problem of introducing the product on the market. For this task, missionary salesmen will be used to call on dealers, arrange for displays, and pass out samples to the public. Eventually such missionary representatives will be given territories of their own and will confine their activities to calling on established wholesalers carrying their line. The present promotional plan calls for intensive cultivation and direction of effort in one or two limited territories. Later on expansion will be made into new areas. Eventually it is hoped that national distribution will be achieved. Do you favor in this case and under these plans for distribution any form of advertising? If so, what kind? Discuss fully, considering both the immediate and the long-range program.

21

PERSONAL SELLING AND SALES PROMOTION

In the preceding chapter it was stated that advertising and personal selling are the two selling methods in common use in our economy, and the advertising phase of selling was treated in some detail there. It is the task of this chapter to present a discussion of the personal selling part of the function and the allied phase designated as sales promotion.

Relative Importance of Personal Selling. If age is a criterion of relative importance, then personal selling must be given prime position. It is by far the oldest form of selling. In every exchange of goods involving a standard medium known as money or its credit substitute, there must always be two parties—buyer and seller. As this bipartite condition has existed from the time that men began to exchange goods by means other than sheer barter, personal selling is as old as is such trade itself. It goes back many centuries before invention of the printing press which made possible the first mass advertising.

If extent of use as an exclusive selling device determines relative importance of the two methods or forms of selling, again personal selling takes first place. To be sure, there are concerns, like mail order houses at the wholesale and retail levels, that sell entirely by means of advertising. The volume of business thus transacted is relatively small, however. On the other hand, there are many thousands of manufacturers and many more thousands of retailers who do not advertise at all, unless window and counter displays by the latter are so considered, but make sales exclusively through personal selling effort.

Commonly, the two methods of selling are used by the same vendor to complement or supplement each other, which makes measurement of relative importance extremely difficult if not impossible. If it is assumed, however,

that businessmen will make the greatest expenditures in manpower and other resources where, by experience, they tend in the long run to obtain the best results, then personal selling must be judged by far the more important method of selling.

While accurate data regarding employment in the two forms for selling are not available, it is readily apparent that personal selling predominates. The number engaged in advertising, including all employees of advertising agencies, advertising departments of advertisers, and sales and promotion departments of advertising media, certainly does not exceed more than one or two hundred thousand. When it is considered that the majority of retail employees are salespeople, that manufacturers and wholesalers have sales forces ranging in size from one to thousands, and that the major types of functional middlemen have numerous selling employees, it is clearly evident that the number engaged in personal selling must aggregate several million persons.

Economic Basis for Personal Selling. There are many people in our present-day society who believe that the work of a salesman is unproductive and hence economically unjustifiable. They entertain the idea that, at best, selling may be a necessary evil and that it adds no value to goods but increases their costs instead. The basis for this misconception is that the mere creation of form utility is often popularly confused with production which, in its broader and more meaningful sense, includes not only form utility but also the creation of time, place, and possession utilities as well.[1] In the vast majority of business transactions, the final value of goods cannot be accounted for without attention to the productive work of the salesman.

Like advertising, the present-day importance of personal selling is an outgrowth of the Industrial Revolution. In the premachine age, salesmen existed but were not greatly in evidence. Most production was for home use or for the use of known purchasers. Wants of the majority of the people were for what we would now consider bare necessities, and the effort of practically the entire work force was required to produce such bare necessities by hand methods; hence personal selling as a specialized activity occupied an inconspicuous position in the economy. The factory system multiplied our productive capacity and made it necessary for most manufacturing establishments to sell over a large geographic region in order to support a volume of production that would justify investment in the capital equipment required for mass production.

Either buyer or seller may initiate contacts in the exchange process. As was explained in Chapter 19, ultimate consumers are usually very active in this respect, especially when their wants are pressing and they have some

[1] This concept of production is more fully developed in Chapter 1.

familiarity with the kinds of goods that will satisfy their wants. Buyers for business firms are also often active in initiating exchange, particularly when they are seeking to fulfill a requirement that is of their own determination. All kinds of buyers are, however, often reluctant or unable to make the most logical purchase when the goods providing maximum satisfaction are new or improved items, or when many alternatives are available and the knowledge of the buyer is naturally quite limited. Under such circumstances, contacts initiated by the seller and involving a human relationship with the buyer are most essential and productive. Even when buyers are most active in contactual relationships, some degree of dependence upon assistance from a salesman is the usual circumstance.

Personal selling activity is a natural and inevitable characteristic of a private enterprise economy in which buyers may purchase from alternative sources without compulsion. In a democratic system with a large number of complementary and competitive productive agencies, the work of the salesman is essential in consummating the exchange of goods between retailers and ultimate consumers, wholesalers and retailers, manufacturers, farmers, and wholesale organizations. It is inconceivable that we could enjoy the benefits of large-scale mass production without the work of the salesman who is the informative link between the various parties engaged in the exchange of goods in our specialized economic system.

Selling and Salesmanship

Regardless of type of vendor or product involved, personal selling invariably comprises certain distinct steps or phases. In addition to adequate knowledge of his product, his company, and its policies, a salesman must acquire the necessary facts about actual and potential customers. He must approach such customers with a view to arousing interest, establish favorable reaction, meet or answer their objections, and properly close the sale. The manner in which each of these steps is performed largely determines success and may frequently have to vary with the type of selling situation.

Service Selling and Creative Salesmanship. Two principal types of personal selling activity may be distinguished—service selling and creative salesmanship. The first type, often referred to as *low-level selling,* involves consummating a sale to a customer who has already made up his mind to buy and who knows, at least approximately, what he wants. Its purpose is to supply the prospective customer with information that will enable him to arrive at a decision to purchase the product offered by the salesman. It involves the processes of making goods available, offering several items from which a choice can be made, explaining the differences between items, making clear the terms of sale, writing up the order, wrapping packages

or arranging for the delivery of merchandise, and other types of service that aid in completing transactions. In service selling, the salesman is usually sought out by the buyer or at least is expected by the buyer because of some established pattern of contactual relationship.

Creative salesmanship, which is often called *high-level selling,* involves the process of arousing demand for new products or new brands or models of products, influencing changes in patronage from one source of supply to another, and causing changes in the concentration of purchases of particular commodities or lines of goods. To do this type of selling requires skill or art in presenting goods in such a manner that neutral or negative attitudes are converted into positive wants or demand. In creative selling, people are persuaded to do what they had not intended to do or had not specially wanted to do, despite basically existing wants warranting contrary reactions. This is accomplished by arousing desires that can be satisfied only by the possession of the products or services offered by the salesman. Relationships between buyers and sellers that involve service selling are often preceded by creative selling effort. Creative selling initially establishes these relationships and opens the way for repeat business, while service selling maintains and cultivates these relationships.

Types of Personal Selling Situations. Selling methods and types of salesmen employed are conditioned by nature of the product or product line and by channels through which it moves. Quite dissimilar problems are encountered in the sale of industrial goods than in the sale of consumer goods, and within each field there are additional variations depending upon whether sales are made to consumers or to middlemen in the channel of distribution.

Selling to Industrial Users. A salesman of highly standardized materials such as sheet iron, cement, or chemicals finds that his principal task is showing just why an order should be given to his firm rather than to a competitor who can supply materials of exactly the same specifications. The coal or fuel oil salesman faces the same problem; although his products are not so highly standardized, they are purchased on the basis of chemical analysis of heat units. In all such cases price considerations are important as are delivery dates and the general reputation of the supplier. Many orders for such goods are placed, nevertheless, because of the personality of the salesman or as the result of pleasant relations with the supplier in the past.

Some sales of standardized goods require a great deal of technical knowledge and a high degree of salesmanship calling for appeals to motives other than those relating to patronage. This is true, for example, in the case of the fuel oil salesman who calls upon an industrial plant that has relied upon coal as a source of heat and power. The sales presentation under such cir-

cumstances must appeal to primary motives, and it necessarily involves very detailed considerations such as the cost of converting burners, storage facilities needed, possible cost savings resulting from the use of the new method, and an analysis of any operating methods and procedures that may be affected by the change.

Salesmen who sell major items of equipment and installations must have a thorough understanding of the production problems of the industry of which their prospects are members. A salesman of rubber belting must be able to analyze the problems of transmitting power in a particular factory and to furnish detailed specifications when he submits a price proposal. Air conditioning equipment, vertical transportation installations, and lighting fixtures are ordinarily purchased by retail establishments only after careful consideration of competing types produced by various companies. In the sale of such products graduate engineers are often employed as salesmen, because only they have the technical knowledge required for a careful analysis of the customer's needs. Such salesmen are appropriately called *sales engineers*. More than mere technical knowledge is needed by sales engineers, however, for they must be able to analyze cost savings and other advantages resulting from new installations. Furthermore, they must be able to arouse latent demand or in many cases create it in the sense of calling forth a hitherto unrecognized need.

Selling to Wholesalers. Salesmen who sell to wholesalers and to buyers in the purchasing organizations of large-scale retailing companies have a distinct problem. Within any specific classification of consumer goods, the number of different products which might be purchased is almost legion. On the other hand, the warehousing and capital resources of the buyer are always limited. Since the buyer can ordinarily purchase only a portion of the available offerings, he is primarily interested in the resalability of different offerings. The principal task of the salesman is often that of convincing the buyer that there is a demand for the products in question and that retail stores will be able to make resales. This may be achieved by an explanation of plans for advertising, by showing window or store display materials, or by proving that demand already exists by obtaining orders from retailers to be filled by the wholesaler. This latter method is a part of what is known as missionary selling. *Missionary salesmen* employed by a manufacturer work with retailers and make store demonstrations, prepare window displays, or arrange for other sales promotional activity. Orders are then accumulated from retailers and given to the wholesaler, but often only after the latter has agreed to buy at least twice the amount called for by the orders already secured. Such missionary work is an important part of the demand creation activities of many manufacturers of specialty drug and food lines.

In addition to showing that there is or will be a demand for their products, salesmen who call on wholesalers must be able to discuss the general distributive organization of the company intelligently, to converse with some expertness on profit margins, and in general, to conduct themselves in a manner that inspires confidence in customers and prospects. A somewhat higher type of salesman, measured by both experience and general ability, is needed for this purpose than for selling to retailers exclusively, except in the case of sales to large retailers such as department stores, chain stores, and mail order houses where skill of just as high an order is required.

Salesmen Who Sell to Retailers. Salesmen who represent manufacturers or wholesalers in their sales to retailers have a task somewhat similar to the one which faces salesmen who sell to wholesalers. All retailers, of course, have limited space and capital resources and are greatly concerned with the resalability of items under consideration. Salesmen dealing with typical retailers do, however, also have a somewhat different problem. They must show the retailer that the source they represent is one from which purchases should be made. Patronage motives are of great importance. Credit policy, freight rates, speed of delivery, and personal relationship are a few of the factors entering into the situation. Usually there are a number of competitors, any one of whom could supply the desired articles.

It is becoming apparent that salesmen of this type should be of such a caliber that they can render service to retailers by giving them advice on buying, on credit problems, on advertising policies, on window displays, and in general help their customers to become better merchants. Such requirements have tended to increase the general ability required and to eliminate persons who can merely take orders but do little or no constructive selling. In fact, many wholesaling organizations have made considerable progress in reorganizing their selling effort by devoting more attention to high-level selling and less to low-level selling of the "order-taking" variety. In the food and drug fields, there are a number of wholesalers who have their salesmen spend most of their time in assistance work with retailers. Routine phases of ordering are sometimes shifted to retailers who determine their own purchasing requirements from preprinted order forms or catalogs. This situation is most commonly encountered in cases where the wholesaler's salesman obtains agreements from retailers to concentrate their purchases with the wholesaler, so that the wholesaler is not continually pressed with the need for winning patronage. By the same token, the wholesaler's representative has more time to contact new accounts and to provide genuine merchandising assistance for regular customers.

Selling to Ultimate Consumers. All but a relatively small proportion of sales to ultimate consumers are made in retail stores. The principal differentiating characteristic of retail store selling is that the consumer usually

seeks out the salesman and usually has a specific want and at least an approximate idea about the means of satisfying it. It is in retail stores that *service* selling assumes the highest degree of significance. Practically all of the retail salesclerk's time is ordinarily spent in showing requested merchandise, writing sales slips, making change, wrapping packages, and maintaining the stock and the general selling area in a condition suitable for customer contacts with the merchandise. There are, nevertheless, numerous opportunities within the store for *creative* selling. These arise out of the possibility of selling the consumer additional quantities of a desired item, selling other items related to the one that the customer enters the store to buy, and uncovering additional unrecognized needs and persuading the customer to purchase the products to meet such needs. Almost anyone who is capable of performing the service activities associated with retail selling can qualify for some kind of a position as a retail salesperson. Such selling is generally characterized by less knowledge and skill than the types of selling previously discussed. To this statement there are exceptions such as are encountered particularly in some establishments or departments selling goods of high unit value and infrequent purchase such as floor coverings, fashion apparel, and home furnishings.

The trend to self-service merchandising has shifted a considerable amount of exchange effort to the consumer and, as explained in Chapter 19, increased his responsibilities as a buyer. There remains, nevertheless, the need for a certain amount of service selling in consummating transactions before the consumer leaves a self-service establishment. In some kinds of stores, a transition to self-service merchandising has actually opened up greater opportunities for high-level or creative salesmanship. For example, many hardware stores are arranged with open display of merchandise and check-out counters. Consumers who know exactly what they want and where to find it can obtain faster service by selecting their own items and paying for them at check-out stations. At the same time, salesmen do not have to spend valuable selling time on such transactions. Instead, they are free to assist other customers who can obtain greater benefits from personal selling effort because their needs are not yet made definite or they need buying counsel which involves technical product knowledge. Illustrative are purchases of power lawn mowers, paint, appliances, or plumbing fittings.

A small but nevertheless significant proportion of retail sales is made at the homes of consumers by specialty salesmen. Some such salesmen are outside employees of regular retail establishments selling items like automobiles and major electrical appliances. Others are employed by manufacturers in the direct sale of products to ultimate consumers as was discussed in Chapter 12. As a rule, emphasis is placed upon ability to stimulate, direct, or divert demand rather than upon technical knowledge. Some organizations selling in the homes of consumers require their salesmen to

canvass all homes in specified areas. When this policy is followed, skill in creative salesmanship is required. Other concerns selling to homes employ direct or publication advertising in order to obtain leads for their specialty salesmen. This eliminates a considerable amount of wasted effort that might ordinarily be expended in calls on prospects who do not have even a remote interest in the product. It also has the result of placing more emphasis on the service aspects of selling.

Sales Promotion

Sales promotion was defined in the preceding chapter as consisting of those selling activities that supplement both advertising and personal selling, coordinate them, and render them more effective. It is a term that is used in the business community with a wide variety of interpretations, there being no general agreement as to the exact number or type of specific activities included within its scope.

Purpose of Sales Promotion. Sales promotion is most highly developed among large manufacturing companies that market highly advertised consumer goods. While this aspect of marketing is not restricted to such companies, its meaning and purpose are clarified by a consideration of the responsibility for selling in a large concern. The advertising department is ordinarily concerned with indirect advertising and mass appeal. Its major responsibility is the preparation of advertisements and their proper placement in suitable media. Personal contact with customers is usually outside the scope of its activities. The personal salesman, on the other hand, has as his responsibility the meeting of prospective customers, delivering a sales presentation, and obtaining orders for the product or product line. He is likely to be irritated by any other activities that reduce the amount of time he is able to spend in obtaining orders. If the work of the sales organization is confined to mass advertising and personal selling activities, the two parts of the organization responsible for these activities are likely to be working at cross-purposes and there are likely to be important gaps in the sales program. To supplement the advertising and personal selling departments, many companies have a sales promotion department as a third part of the sales organization. This department supplements the other two by coordinating their efforts and rounds out the sales program by maintaining liaison with dealers and consumers. Among the most important of the numerous duties commonly assigned to a sales promotion department are the following: point-of-purchase advertising and display, dealer merchandising aids, premiums, contests, coupons, samples, and demonstrations. In small companies whose operations cannot support a specialized sales promotion department, many of these activities are nevertheless carried on by the

advertising department, the personal selling department, or by the two of them working in close cooperation.

Point-of-Purchase Advertising and Display. A manufacturer of consumer goods is particularly interested in advertising and display in establishments where his product is sold to ultimate consumers, for two reasons. First, between the time that an impression is made upon a consumer by mass advertising and the time of a visit to an establishment where the merchandise is sold there may be many obstacles to purchasing. The impact of publication or broadcast advertising may have been slight; the consumer is often exposed to competing advertising which makes an equal or stronger impact; or the consumer may find competing products more prominently displayed in stores. Second, since practically all consumers visit retail stores, widespread point-of-purchase advertising is likely to be seen by nearly everyone, even by those who have not seen a magazine or newspaper advertisement or heard a radio commercial pertaining to the product. Where self-service and self-selection merchandising methods are used, the point-of-purchase display acts as a substitute for the retail sales clerk, providing information which contributes to the buying decision.

Point-of-purchase promotion effort takes two principal forms, window and interior display. A wide range of materials is used for display purposes including the product itself, dummy packages, giant package facsimiles, lithographed display cards, photographs, streamers, metal signs, floor stands, merchandise display fixtures, decalcomanias for windows and store entrances, and wall signs. A large proportion of such material is distributed free to retail stores and is never used for the intended purpose in the retail establishment. To overcome such waste, some manufacturers have discontinued the distribution of point-of-sale advertising material by mail but instead distribute it only through personal salesmen who have been trained in educating the dealer to the value of display and in securing cooperation for its effective use. When large window or interior display space is desired by a manufacturer, it is often necessary to compensate the dealer for its use in some manner. This is occasionally done by a cash payment but more frequently by a special deal involving an additional discount on all merchandise purchased for the display or by an offer of free goods.

Dealer Aids. A considerable amount of sales promotion effort is devoted to merchandising assistance given to dealers. Such efforts are largely confined to companies whose line of merchandise is of considerable importance to the dealer. This is the situation when a manufacturer has a wide line of merchandise or when he restricts his distribution to a very limited number of outlets that are expected to give considerable promotional effort to his line. On this basis, a wholesaler with a wide variety and assortment of merchandise is in an excellent position to use dealer aids.

Undoubtedly the most common type of assistance is in advertising. A second very important form of dealer assistance consists of training programs or educational material furnished for retail store employees selling a manufacturer's product. Some manufacturers and wholesale distributors provide very comprehensive forms of merchandising assistance that are store-wide in scope. In addition to advertising assistance and personal selling training, this may involve furnishing and installing accounting systems, stock control systems, and assistance in problems of store modernization and layout.

Direct Consumer Stimulants. Manufacturers and distributors employ a number of techniques which are intended to stimulate more direct purchasing action than can ordinarily be effected through mass advertising and personal selling appeals. Illustrative are premiums, contests, coupons, samples, and demonstrations in retail stores. *Premiums* may be defined as articles of merchandise offered as inducements to purchase a product. While almost all types of consumer products have been promoted, at some time or another, by the use of premiums, they are most commonly employed by manufacturers of highly competitive products of low unit value and frequent purchase. *Contests* in which the consumer is asked to write a sentence about a product, complete a verse, work a puzzle, or suggest a new use for a product are a very common method of direct stimulation. Great interest usually results from publicity accorded to the substantial prizes offered in such affairs. This interest is accentuated by the average person's natural desire to play or compete. Special purchase offers are often made by *coupons* distributed to the homes of consumers, usually through the mails. They are most commonly employed to encourage immediate purchasing action by the offer of a special price good only within a specified period of time.

The use of *samples* for customer stimulation is based upon the idea that the best salesman for the product is the product itself. This obviously limits sampling to products of genuine merit. This method of promotion is also limited to products of low unit value and frequent purchase. Samples of high unit value products are too costly. If goods are not used or purchased frequently, the effect of the sample is forgotten before there is occasion to purchase such a product. Typical of items promoted by samples are cigarettes, cosmetics, drugs, prepared breakfast cereals, tooth paste and powder, baby food, and candy. Full-size packages are sometimes distributed as samples. It is more common, however, to find samples prepared in special packages, the size of which is determined by the minimum quantity that permits a reasonable trial of the item. Samples are distributed in a number of ways. Products of widespread use and very low unit value are often distributed free to all consuming units in an area, either through the mails or by house-to-house canvassers specially employed for the purpose. Another

method of free distribution is through retail stores selling the product. Still a third method is publicizing the availability of the sample in advertisements. When this is done, a person desiring a sample has to take direct action in order to obtain it, with the result that distribution is restricted to those who have a definite interest in the product. In order to restrict distribution still further, a nominal charge is sometimes advertised in connection with the offer.

Demonstrations are an effective method of consumer stimulation for products of a technical nature, for products having a variety of uses, or when the proper use or application of the product is not readily apparent. They vary in scope from elaborate field test demonstrations frequently conducted by farm implement manufacturers, to the free home demonstration of a television set for a limited trial period, or to the operation of hand-wound mechanical toys on the variety store counter. In the cosmetics trade, use of manufacturer-trained and compensated demonstrators in retail stores has been a common practice. Such demonstrators are loaned to large department stores and are known as "hidden demonstrators" because their true employer is not known to the consuming public. The store benefits because it does not have to pay wages to the demonstrator but nevertheless realizes its normal gross margin of profit on all sales resulting from the demonstrator's efforts. The manufacturer benefits by having his own representative in contact with the consuming public in an influential retail establishment. The widespread use of manufacturer-compensated demonstrators in large retail stores has resulted in a number of court cases brought under the provision of the Robinson-Patman Act that prohibits advertising allowances unless they are made available on proportionally equal terms to all customers. When a seller makes demonstrators available to large retail stores, he must ordinarily provide smaller stores handling the line with some promotional service or allowance of proportionally equal value. Samples and demonstrations differ from premiums, coupons, and contests in their purpose which is that of educating the consumer in the use and value of the product. Emphasis is upon the merits of the merchandise rather than upon unrelated appeals.

Sales Promotion by Retailers. Retail sales promotion activities are motivated principally by the desire to attract patronage and only occasionally by the intention of selling particular items of merchandise. Sales promotion activities, other than regular advertising in local media, are so numerous and diverse that they are very difficult to classify. For purposes of this brief discussion, it may be helpful to group them into two broad categories. First, there are many sales promotion efforts which are closely identified with the kind of merchandise or services offered by a store. A few familiar examples include window and special interior displays of merchandise,

fashion shows by apparel retailers, cooking schools by household appliance dealers, model homes decorated by furniture stores, and provision of special shopping services for male customers in women's stores during important gift buying seasons. When such activities are soundly conceived and administered, they are beneficial to merchants and are also laudable from a social viewpoint. They often build long-run good will for the sponsoring establishment as well as contribute directly to immediate sales volume gains. They also may be productive of consumer satisfaction by the utilization of merchandise that would not otherwise be purchased, or by the better utilization of merchandise or services thus promoted.

A second type of sales promotional activity embodies those which have no basic relationship to the store using them. Common illustrations include automobiles or other prizes given away as a result of drawings for which patronage is required for eligibility; free gifts of toys for children who visit an establishment in company with their parents; punch cards which entitle the customer to purchase nonrelated merchandise items at a substantial discount after purchasing a certain volume of goods; and trading stamps redeemable in merchandise distributed by a stamp plan company. From an economic standpoint, activities in this class are almost altogether purely competitive in nature. Their success is largely dependent upon ability to divert patronage from other retailers or to hold patronage which would otherwise be lost to competing stores. Whether such activities have a significant long-run effect upon total consumption is debatable.

The soundness of many activities in this second group may be questioned from the standpoint of retailers. In extreme cases, they are attempts to win patronage by artifice or subterfuge. Large expenditures of managerial time and money for sales promotion devices that are not basically related to the merchandise offerings or character of a particular store may win patronage but on a precarious basis. While new customers may be enticed, they are also easily wooed away by similar stratagems of competitors. Comparable expenditures in a well-conceived advertising and selling program which is related to demonstrable advantages of the merchant are more productive of lasting benefits.

The competitive character of some retail sales promotion activities may be illustrated with reference to *trading stamp plans* which were used on a wide scale in the depression of the 1930's, virtually disappeared from the scene with the coming of World War II, and experienced an extremely lusty revival in the mid-1950's. As a general rule, trading stamps are purchased by retailers from trading stamp companies and distributed to consumers at the rate of one stamp for each ten cents worth of consumer purchases. The rate of distribution is such that the stamps cost the retailer about two or three cents for each dollar of sales. When the consumer accumulates a large quantity of stamps, which are usually pasted in books,

they may be redeemed for miscellaneous merchandise and at a redemption value usually about two-thirds of the cost of the stamps. About one-third of the stamp cost goes to the stamp company to cover the expenses of its operation and to provide it with a net profit.

When stamp plans are new in a community, the first participating merchants often experience a marked increase in patronage. When rivals retaliate with comparable stamp plans, the competitive advantage is lost and trade is likely to resume its former distribution.[2] These effects are most easily visualized with reference to the grocery field where their use has been most common. It is rather obvious that the use of such stamps will not significantly increase total consumption of food products. When a number of major chain food organizations are involved in competitive stamp plans, it is not possible for them to increase their individual volume to the point that they can absorb the cost of the stamps. Net profit margins among retail food chains are only about one or at most two per cent of sales, which is less than the typical cost of purchasing the stamps. Thus, it is inevitable that the cost of the stamps must be passed on to the consumer in the form of higher markups on merchandise. Wide-scale competitive activity of this kind, consequently, adds more to the cost of marketing than to the creation of utilities.

Conclusion. From the foregoing discussion it is apparent that there is no clear dividing line between sales promotion on the one hand and advertising and personal selling on the other. When advertising is conceived as any paid form of nonpersonal presentation of goods to a group and personal selling is viewed as the process of personally assisting and persuading an individual prospect, it is evident that the methods of sales promotion discussed above involve some combination of both advertising and personal selling activity. Undoubtedly the most important justification for their separate consideration is the specialized responsibility for performance among larger marketing organizations. The cost of materials used for sales promotion effort is included within the reported advertising cost ratios for most companies and has been reflected in the discussion of the cost of advertising considered in the preceding chapter. The cost of securing dealer cooperation and distributing sales promotion material, on the other hand, is generally a part of personal selling costs of marketing establishments.

No additional social or economic questions are raised by specialized attention devoted to sales promotion. In general, its services are the same as those stated for advertising, and criticisms of it fall into the same general

[2] In some communities there are a half-dozen or more competitive stamp plans. It has been estimated that about 400 different companies were offering stamp plan promotions to retailers throughout the United States in 1955. *New York Retailer,* November, 1955, p. 3.

pattern; furthermore, it is subject to the same general control as advertising from which it cannot always be clearly distinguished.

Questions and Problems

1. Define or briefly explain the meaning of each of the following terms:

   a) service selling
   b) creative salesmanship
   c) missionary salesmen
   d) point-of-purchase advertising
   e) premiums
   f) merchandise coupons
   g) hidden demonstrators
   h) trading stamps
   i) sales engineer

2. Is it possible that the adoption of self-service merchandise techniques by a retailer can open new opportunities for creative salesmanship in his store? Explain and illustrate.

3. Illustrate and explain several types of personal selling situations where the salesman must emphasize appeals to:

   a) Primary buying motives
   b) Selective buying motives
   c) Patronage motives

4. Mention several types of sales situations where personality is likely to be more important to the salesman than product knowledge. Mention several situations where the reverse is true. Explain your examples.

5. Why would a manufacturer be interested in providing training material for retail store employees? Is there any reason why a retailer should be cautious in permitting the use of such material in his store? Certain manufacturers offer as a dealer service the preparation of complete and detailed store layout plans. Should the retailer observe any caution in evaluating such plans? Explain. Give several examples of manufacturers that might employ such methods of sales promotion and several that undoubtedly would never consider this type of dealer aid.

6. Explain how the personal selling task differs in the following pairs of situations:

   a) Selling to ultimate consumers in a retail store and selling to ultimate consumers by house-to-house canvassing
   b) Selling in the floor coverings department of the department store and selling at the notions counter in the variety store
   c) Selling standardized raw materials and selling major installations to industry
   d) Selling by a wholesale druggist's salesman to a prospective customer and to an established customer of the house
   e) A wholesale grocer's salesman selling a new food product to an independent merchant and a manufacturer's salesman selling the same product to a buyer for a large chain organization operating more than 500 supermarkets

7. Illustrate several types of opportunities for creative selling often encountered by alert retail salespeople.

8. What kind of products can be successfully promoted by the use of samples? By the use of demonstrations? Are there types of products that cannot be promoted by these methods of sales promotion? Explain.

9. The Hartman Company is a manufacturer of a well-known brand of household wax products which are distributed through wholesalers and chain store warehouses to retail stores. Some sales are made direct to large department stores. The company has a large sales force that makes regular calls on such customers. Each salesman has a specific territory and calls on each customer about once a month. Salesmen are supervised through eight district offices located in different cities in various parts of the country. The eight district sales managers report to the Vice President in Charge of Sales, who has complete responsibility for the personal selling efforts of the company. District sales managers select, train, and supervise the salesmen in their own areas, but are guided by general policies which are determined by the Vice President for Sales.

   The company has recently been engaged in extensive product research and has developed a new wax preparation which should prove useful in the processing of certain food items. A number of kinds of fruits and vegetables can be coated with this preparation and shipped to distant markets with less handling damage or spoilage, thus arriving in better condition. All sales to date have been on an experimental basis, but the company is now convinced that a very substantial market exists and has taken preliminary steps to produce the new product in large quantity. Major prospects are large growers and shippers of fresh farm produce.

   If the product is to be marketed successfully, what problems relating to the organization and management of personal selling activities will have to be resolved?

10. Joseph Kuhlman is the owner of a self-service grocery in a small midwestern community. He has just been approached by a representative of a stamp plan company. Trading stamps have not been used by any merchants in this community as yet, but there has been considerable discussion of them by merchants because of conspicuous promotion in a major metropolitan area some 60 miles away. The stamp company salesman has explained that his organization will provide stamps to the merchant at a cost of $2.80 per 1,000, in books of 5,000 stamps. The stamps are to be given to customers, one for each ten cents of merchandise purchased. Customers paste the stamps in books which hold 1,200 stamps. The company maintains a display store in the nearby metropolitan area where stamp books may be redeemed in merchandise by customers. Such merchandise includes silverware, luggage, towels and linens, household appliances, jewelry and clocks, and many other items. The number of books required for redemption depends on the retail value of each item.

   During the past twelve months, Kuhlman did a business of $400,000. His gross profit (difference between sales and cost of goods sold) was $74,000. Of this, $68,000 went for the expenses of operating the business, leaving a net profit of $6,000. Of the total expenses, $40,000 consists of items which are fixed in amount from one year to another and $28,000 consists of variable items which fluctuate in some direct relationship with the volume of sales.

   The stamp plan salesman presented testimonial letters from grocers in other communities. Such letters included statements that increases of 20

to 40 per cent of sales had been experienced after starting the trading stamp plan. He explained that Kuhlman would have exclusive rights to the plan for the grocery field, but that progressive merchants in other lines of trade would be solicited for participation, so that the plan could be promoted on a community-wide basis. He explained further that two other grocers had expressed an interest in the plan, so that he could give Kuhlman only two days to make a decision.

How should Kuhlman determine whether to participate in the plan?

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TRANSPORTATION AND MARKETING

Functions of exchange are necessarily the principal and most essential marketing functions. They embrace all buying and selling activities which have been discussed in the three preceding chapters. To give effect to the exchange functions, the goods must be supplied. Following the creation of form utility, this is done through the performance of two other marketing functions, namely, transportation and storage, which are usually designated as functions of physical supply. The importance of these latter activities, the way in which they are performed, and their relation to the entire marketing process are indicated in this chapter and the one that follows.

What is Expected of Our Transportation System. To a very great degree our marketing system is built upon and presupposes an economical and effective transportation system. Large-scale agriculture and manufacturing assumes that facilities for distributing commodities over a wide area are always available. The development of the factory system which followed the basic textile and power inventions could not have taken place had there not been an accompanying development of relatively cheap and efficient transportation. Today, our economic system places four major demands upon transportation. These are: (1) that it shall be adequate to meet all normal demands, (2) that it shall be speedy and thus aid in reducing the time elapsing between the creation of form utility and consumption, (3) that it shall furnish the number and variety of services which are needed to make our marketing structure function with the highest degree of efficiency, and (4) that the cost of providing transportation shall be reasonable and in accordance with the true worth of the services rendered.

In a broad sense, transportation involves all kinds of movements of persons and goods from one place to another. This includes *internal* move-

ments within business establishments, as handled by elevators, electric stairways, and other kinds of gravity and power conveyances; it includes strictly *local* movements of people and commodities within a market area; and it includes movements *between markets*. In this book, the discussion of transportation is confined to the role of this function as part of the marketing process. Furthermore, the treatment is limited to *intermarket* or intercity movements of commodities. Internal and local market movements, while of great interest and importance, are not examined here because the former are internal management problems and the latter are largely services of marketing institutions, handled to a great extent by their own equipment, and have been given appropriate attention in the sections of this book dealing with retailing and wholesaling.

Economic Basis for Transportation Service. It is the function of transportation to convey commodities from places where their utility is relatively low to places where it is higher. Because of the location of natural resources, variations in climatic conditions, concentrations of skilled or unskilled labor, large-scale manufacturing, and a high degree of specialization, many commodities are raised or manufactured largely or exclusively in certain places or regions. As a rule, commodities are of greater value (have greater capacity of satisfying human wants and desires) when at or near points of consumption than when they are at distant points of agricultural production or manufacture. Bananas and coffee are of relatively more value in the United States where they are largely consumed than in Central America where they are produced. Texas citrus fruits are of relatively greater value in the North Central States than in the Rio Grande valley. Thus the principal economic basis for transportation is in enhancing the value of goods by the creation of *place utility*.

Incidental to the performance of the transportation function goods must be stored, often for considerable periods, in railroad cars, on trucks, or in the holds of ships while en route to market. As a rule, the *time* involved in the transportation process has a negative value or disutility, and every effort is ordinarily made to reduce it to a minimum. Occasionally, however, this time may be used to ripen or otherwise to condition the products transported, thereby adding to them *time utility* and thus further enhancing their value. Time utility may also be created when shippers and consignees utilize transportation facilities for storage purposes. To minimize the use of transportation facilities as a means for storage, a limited amount of time is ordinarily allowed for removing goods shipped in car lots after the car is delivered to the consignee, and a *demurrage* fee is charged for every day the goods remain stored in the car after the period of grace. Similarly, a limited time is allowed for the removal of smaller shipments from freight warehouses after arrival at destination. In any

event, time utility is often created in connection with the movement of goods from place to place where the primary aim is the creation of place utility.

Transportation and Economies in the Production of Form Utility. In the long run, the price paid for a commodity must cover all the costs incurred in its production. One of these costs is that of transporting the finished commodity, and the parts, supplies, equipment and raw materials entering into it, once or a number of times before it reaches the place of consumption. There are many goods like spices, fashion apparel, and jewelry for which the cost of transportation is only a very small component of the final price paid by the consumer. On the other hand, most of the trade of the United States is in products which are in an economic sense bulky, i.e., of appreciable costliness in transportation relative to their value. Illustrative are most food products, construction materials, oil and oil products, coal and minerals, and practically all raw materials.

Generally speaking, transportation costs make up a relatively large part of the final prices of commodities that are relatively heavy or bulky, require special transportation service, or must be moved considerable distances. The cost of transportation is ordinarily, however, more than offset by two distinct types of economies in the production of form utility. One is *occupational and technical division of labor,* the advantages of which can exist only under large-scale operation. With but few exceptions, industries that sell exclusively in the communities of their location cannot be operated on the most efficient scale. Transportation opens a far wider and larger market and thereby encourages large-scale industrial activity.

Second, transportation makes possible the advantages of a *geographical division of labor,* since certain communities are especially well adapted for growing or making certain types of commodities. Their advantage may be due to climatic conditions, to the presence of inexpensive or adequate supplies of efficient labor, or to the proximity of necessary raw materials or semi-manufactured goods. As a result of such geographical division of labor, some communities become highly specialized. This is witnessed by a number of communities around Zanesville, Ohio, where art tile and pottery manufacturing predominates. Also illustrative is the concentration of shoe production in the vicinity of St. Louis and Boston. The significance of the Detroit area as an automobile center and of Akron as an automobile tire and rubber products city is similarly explained. Large cities and smaller highly specialized communities could not exist in the absence of modern transportation methods which take the commodities that continuously pour out in a wide stream from their factories to the rest of the world and in turn bring in the necessary raw materials, supplies, and equipment.

Basic Types of Freight Transportation Service. The kind and quality of service demanded of our transportation system vary with the class of freight to be moved from place to place. Even though there are numerous types of goods with multifarious physical characteristics, practically all goods may be grouped into one of two broad classes with respect to transportation service requirements. One of these consists of basic commodities that are ordinarily shipped in very large volume and require only *bulk freight service*. Illustrative of such commodities are the relatively nonperishable products of agriculture such as grains and livestock, lumber and other forest products, coal and iron ore, and some semi-manufactured goods that require no special protection or service in transit. The primary requirement of a carrier of bulk freight is ability to move tremendous physical quantities at a very low cost. Speed, special services, and conveniences are secondary considerations. Bulk freight carriers ordinarily do not compete directly with carriers of the second major class of commodities designated as *merchandise freight*. Ordinarily merchandise freight moves in smaller physical volume than bulk freight although the actual physical quantities, such as in the case of California or Florida oranges, may involve a number of full rail cars in a single shipment. The principal requirements of merchandise freight are speed of service, regular and dependable schedules, special merchandise protection, safety, and effective handling services. Cost of movement, while important, is often a secondary consideration.

Freight Service Agencies

The various practical methods for effective intercity movements of commodities are highly institutionalized. Each method is reflected by a major kind of freight service agency. The existence of a variety of such agencies constitutes a complex of alternatives in many marketing situations. Selection of the agency or agencies best suited to intermarket movements under given conditions is a task involving great economic consequences.

Railroads. As shown by the data in Table 21, railroads are by far the most important type of transportation agency. About 50 per cent of the total tonnage of intercity domestic freight moves by rail. The relative position of railroads has, however, declined considerably in the years following World War II, accompanied by increases in the relative position of motor truck carriers and oil and gas pipelines.

Railroads are principally important as bulk freight carriers. More than 99 per cent of the tonnage shipped by rail consists of carload shipments and more than 70 per cent consists of products of mines, agriculture, and forests.[1] In order to accommodate mass bulk movements, railroads have

[1] *Yearbook of Railway Information* (1955 ed.; Eastern Railroad Presidents Conference), p. 27.

developed special types of equipment for coal, stone, grain, petroleum products, cement and other homogeneous products shipped in bulk. Elaborate facilities have also been provided at various points for loading and unloading such commodities. Specialized freight-carrying equipment has proved more economical for most bulk shipments, even though this often involves moving empty cars in one direction.

In the movement of merchandise freight, railroads are chiefly important in connection with long haul, large quantity shipments. Several special features have been developed to reduce costs and minimize hazards in moving some high class merchandise. *Refrigerator cars* have had a profound effect upon marketing methods and structure. For example, they have made it possible for large meat packers to distribute from a few producing centers over large consuming regions through branch wholesale distribution centers. Similarly, citrus fruit growers of California, Texas, and Florida, as well as shippers of many other perishable fruits and vegetables, could not reach their present widespread markets without such service.

Fast-freight lines operating on passenger-like schedules between certain principal cities are another special feature. Such lines are commonly used for carload shipments of perishables and for less-than-carload shipments of manufactured goods which are usually picked up from the shipper by the railroads and which are delivered to the consignee's place of business at destination. In spite of such service, the railroads have been consistently

TABLE 21

DISTRIBUTION OF TOTAL REVENUE TON-MILES OF DOMESTIC INTERCITY FREIGHT[a] TRAFFIC EXCLUSIVE OF COASTWISE AND INTERCOASTAL VESSEL TRAFFIC—UNITED STATES SELECTED YEARS, 1939–1955

Year	Total Ton miles (millions)	Per Cent of Total: Railroads[b]	Motor Trucks	Inland Waterways[d]	Oil Pipe Lines	Air Carriers
1939	536,182	63.2	9.8	16.6	10.4	[e]
1944	1,074,899	69.5	5.4	12.7	12.4	0.01
1947	1,007,469	66.0	10.1	13.5	10.4	0.02
1950	1,048,329	57.0	16.2	14.5	12.3	0.03
1953	1,167,884	52.6	17.7	15.5	14.2	0.04
1954	1,081,450	51.5	19.2	13.7	15.6	0.04
1955	1,259,475	50.0	19.4	15.0	15.5	0.04

[a] Includes intercity freight traffic by private as well as by contract and common carriers

[b] Steam and electric railways, including mail and express

[c] Highway ton-miles include movements between cities and between rural areas and urban areas, rural-to-rural movements city deliveries and city movements to contiguous suburbs are omitted

[d] Includes domestic traffic on the Great Lakes, rivers, and canals, does not include ocean borne commerce between U S ports

[e] Less than 0.005 per cent

Source *Yearbook of Railroad Information* (1955 ed., Eastern Railroad Presidents Conference), p 4, also *Railroad Facts* (1956 ed, Chicago Association of Western Railways).

losing out to motor trucks which have speed and flexibility advantages in relatively short haul movements of merchandise freight.

To encourage shipments of merchandise freight in economical quantities, a wide differential has been established between *c.l.* (*carload*) and *l.c.l.* (*less than carload*) freight rates. While there are some exceptions, carload rates are generally only about one-half or less of l.c.l. rates. These lower rates are justified in large part because the railroad is usually relieved of loading and assembling activities at the origin and of unloading and distribution services at terminals. An additional factor is that checking, billing, and collection costs are relatively much less on full carloads than on smaller shipments. Carload shipments involve minimum weights for each commodity or class of commodity. The bulkiness or density of the commodity determines the minimum weight. For example, some items of crated furniture involve carload minimums of 16,000 pounds whereas the minimum for some iron and steel products is 40,000 pounds.

Loss of considerable merchandise freight revenue to motor truck carriers in the years following World War II has led a number of railroads to inaugurate *piggy-back* service, which involves a form of coordination between local motor and long-distance rail service. The term "piggy back" arises out of the practice of hauling loaded truck trailers on specially designed rail flatcars. Such trailers can be loaded at point of shipment, hauled to rail shipping facilities, placed on flatcars without any merchandise handling, moved over the rails to the destination city, hauled from rail sidings to the point of ultimate delivery, again without the need for merchandise handling at the rail facilities. Special equipment has been developed to increase the speed of loading and to reduce the weight of flatcars and truck trailers. This development holds considerable promise for the *long-distance* movement of merchandise freight where it is possible for railroads to achieve a shipping time advantage over motor truck carriers. When applied to transportation by water, it is known as *fishy-back* service.

Waterways. Inland waterways have accounted for about 13 to 15 per cent of the total domestic freight in non-war years (Table 21). Water carriers are almost exclusively bulk service agencies of which there are several types. On our *major rivers,* such as the Mississippi and Ohio, Diesel-propelled towboats push a number of special barges which may carry as much freight as several long freight trains. The principal commodities transported on rivers are coal, coke, sand, gravel, petroleum products, semi-manufactured iron and steel, grain, and cement. Most of these can be stored cheaply and therefore seasonal river transportation is satisfactory. On the *Great Lakes,* ore, grain, coal, and stone are carried by very large specialized cargo vessels made possible by the channel depths of the lakes and the huge locks that have been built.

Water transportation is actually much more important than indicated above because there is a large amount of *intercoastal* and *coastwise* ocean-borne commerce between United States ports which is not included in the data shown in Table 21. Large fleets of coal-carrying vessels and petroleum tankers operate between ports on the Atlantic seaboard and the Gulf of Mexico and provide the most economical means of transportation between the ports so situated. This type of water transportation is expected to increase considerably in the 1960's after completion of the St. Lawrence Seaway. This joint United States-Canadian project, approved by Congress in 1954, will convert a number of Great Lakes cities into seaports. Thus Buffalo, Cleveland, Toledo, Milwaukee, and Chicago will be directly accessible to ocean-borne commerce, both from overseas and from United States coastal ports.

Oil Pipelines. The oil pipeline is, obviously, altogether a form of bulk service transportation—one which grew from a position accounting for about 10 per cent of intercity freight movement in 1939 to more than 15 per cent in 1954 and 1955 (see Table 21). Although legally common carriers, the inflexibility of existing pipeline routes has confined the use of specific lines largely to the transportation of products of their owners who are, with some notable exceptions, major oil companies. Via pipelines it is possible to transport petroleum products between major shipping points more economically than by rail, but they cannot match the economy of ocean-going tankers. For this reason, a large proportion of the petroleum products consumed along the eastern seaboard is moved by a combination of pipelines and tanker service, the former connecting producing fields with ports on the Gulf of Mexico from which tankers carry the products to Atlantic ports.

Motor Truck Carriers. Private and public motor truck carriers have greatly increased in relative importance. Prior to World War II, they accounted for only about one-tenth of domestic *intercity* freight tonnage, but this proportion had just about doubled by 1955. This is of course a great understatement of the significance of the motor truck as the data do not include *local* movements of commodities such as deliveries from manufacturers, wholesalers, and retail stores to their customers.

The regular motor truck and the tractor-trailer combination are natural merchandise freight carriers that enjoy advantages of flexibility and, over short distances, speed combined with low cost of movement. Not being limited by fixed routes as determined by roadbeds of railroads or natural waterways, the truck is free to go almost anywhere, and it makes possible loading of shipments at points of origin, transporting them in a through movement without transfer, and unloading at the actual ultimate destination. Lower costs of movement for merchandise freight are experienced

over short distances than by rail or by ship because the latter types require a combination of equipment involving motor trucks for pickup and delivery. Also, terminal handling costs are high, and poor utilization of equipment is the usual situation in short hauls by ship or rail. Greater speed results from the elimination of some terminal handling and exchange. No time is lost in switching cars to make up or break up trains in freight yards.

Like the railroads, motor truck carriers have established substantial differentials in rates for *l.t.l.* (*less than truckload*) and *t.l.* (*truckload*) freight. For most commodities t.l. rates are 30 to 50 per cent less than the l.t.l. rates. In general, motor freight rates are lower than rail rates for the same commodities—especially for l.t.l. freight moving over relatively short distances. T.l. rates tend to be slightly higher than rail c.l. rates over long distances, but since trucks are loaded at point of shipment and unloaded at destination, there is a cost advantage even in long haul shipments in situations where rail sidings are not available both at the location of the shipper and at the warehouse or plant of the receiver. Trucks have an advantage in speed even over considerable distances, except between some cities which are served by special fast freight lines or by freight forwarders.

Freight Forwarders. Freight forwarders are specialized merchandise freight agencies that act as representatives of shippers in arranging for billing and handling of shipments. They do not own transportation equipment themselves but arrange with local truckers to pick up and deliver shipments which are moved between originating and terminal cities by rail. The function of the freight forwarder is that of consolidating l.c.l. shipments from several manufacturers, distributors, or other shippers into carload lots. By assembling a number of small shipments into car lots, the forwarder obtains a carload rate from the railroad. This permits him to quote the shipper a rate which is no higher than, and usually not as high as, the regular l.c.l. rate for the merchandise. The spread between c.l. and l.c.l. rates is the forwarder's source of operating revenue. From the amount collected from shippers, he must pay the railroad the c.l. rate and the residue is used to cover the cost of soliciting business, picking up shipments for delivery, filling cars, delivering shipments to consignees, handling and settling claims, billing shippers, and to yield a net profit on the enterprise.

Use of a freight forwarder is explained mainly by the greater speed of handling l.c.l. shipments than would otherwise obtain, simply because he consolidates shipments that might otherwise travel over several railroads. In Cleveland, Ohio, for example, there are five railroads that compete for freight business to distant western points. On most days it is unlikely that each one of these roads would have enough l.c.l. freight to make a full carload shipment to some distant point such as Kansas City. The roads usually

hold l.c.l. shipments until a full car can be loaded, or start a partly filled car which is delayed at intermediate points for loading additional freight to the same destination. The forwarder, on the other hand, collects in one day Kansas City shipments from a number of Cleveland manufacturers and distributors and consolidates them in one full car that moves over only one of the five competing roads.

Freight forwarders handle high-class merchandise freight. They operate principally between major cities, and thus are able to fill cars quickly without delay in origin or in transit. They provide the shipper with the services of a traffic department, selecting the best routes and the most economical shipping techniques, and assuming the general responsibilities of a common carrier. About 40 per cent of the total tonnage of rail l.c.l. shipments is handled by freight forwarders.[2] When shipments involve distances of about 400 to 800 miles, forwarders often consolidate into truckloads, to be carried by regular truck lines, rather than rail carloads. Freight forwarders are not ordinarily used on shipments of less than 300 or 400 miles because of the greater efficiency with which local or regional motor truck carriers operate over such shorter distances.

Although there are over 100 freight forwarding companies in the United States, three large companies enjoy most of the business. Each of these has a large number of receiving stations which are located in the strategic freight-originating cities.[3] With the development of air transportation, as discussed in a following section, freight forwarder service has become of some importance in that field, with relationships between air freight carriers and freight forwarders being similar to those between railroads and forwarders.

Railway Express. The Railway Express Agency offers a premium type of freight service ordinarily used for small shipments of valuable or highly perishable merchandise. Shipments move on schedule and at passenger train speed and can be sent to any city or village in the country which has a railway station. This is a distinct advantage over the fast freight lines operated by railroads or served by freight forwarders that are limited to connections between principal cities. The same is true of air shipments and, to some degree, even of motor trucks, since trucks operating on regular fast schedules do not attempt to service all small communities on their routes.

[2] *Yearbook of Railroad Information* (1955 ed.) *op. cit.*, p. 27. From 1947 to 1955 forwarder traffic in tons originated increased a little over 10 per cent, while total l.c.l. traffic decreased 69 per cent (*Transport Economics*, Monthly Comment by Bureau of Transport Economics and Statistics, Interstate Commerce Commission, July 1956, p. 12). It is believed that the increase in forwarder traffic has contributed to the decline in total l.c.l. volume.

[3] The three largest companies are National Carloading Corp., Acme Fast Freight, Inc., and Universal Carloading & Distributing Co., Inc. Acme is privately owned, but a large proportion of the stock in the other two is held by railroad-operating companies.

Railway express includes both pick-up and delivery service. An important advantage is the ability to insure packages for almost any amount, which accounts for the widespread use of the service in the distribution of merchandise of high unit value. Although more costly, express service is generally faster, more dependable, and involves more careful handling of merchandise than parcel post.

Parcel Post. The parcel post system, established in 1913, has had a marked effect on marketing developments. The large mail order companies have been important beneficiaries. Before the advent of parcel post, railway express was the only alternative to the payment of freight charges based on a minimum shipment of 100 pounds. Many mail order shipments weighed only a few pounds and even railway express service provided no opportunity for delivery direct to customers in rural areas.

By regulation, parcel post is limited to small shipments. Maximum size of parcel is 72 inches in length and girth, and maximum weight is either 40 or 20 pounds, depending upon the distance involved in the shipment.[4] Parcel post is used when the greater speed, special handling, or insurance features of express service are not of great importance. As was indicated above, the cost is generally lower than on shipment by express, although this advantage is offset to some extent by the fact that parcels are not collected directly from shippers.

Air Carriers. Merchandise movements by air carriers take the form of express or freight shipments. Until about the middle 1940's, express was the only form of air merchandise service generally available. The Railway Express Agency serves as the collecting and distributing agency for air express shipments which are carried on the regularly operating equipment of the domestic airlines. The advantages of air express shipments are substantially those of railway express with the addition of much greater speed of movement. Rates are, however, considerably higher than for rail express shipments.

In the years following World War II, airlines began to employ large regular cargo planes to provide a general merchandise freight service at lower rates than air express which generally moves in regular airline passenger equipment. Cargo planes approach the cubic carrying capacity of rail box cars although they are generally not capable of carrying equivalent weights, at least over appreciable distances. Air freight is much more costly than surface shipment of any kind; and its use, at the current stage of development, is limited to merchandise that can stand very high transportation costs because of the urgency of delivery, high value, or great risks from perishability. In spite of substantial year-to-year advances in the total

[4] *Domestic Postal Regulations,* United States Post Office Department, amended to March 1, 1952.

tonnage of air freight shipments, this type of service accounts for only a very small fraction of one per cent of total intercity freight movement (see Table 21). The service has, however, set new standards in speed for *long distance* freight shipments which have had a marked effect on the marketing operations of many concerns. A shipper in any major traffic city can be assured of delivery in almost any other major city the morning after the day on which the shipment is made. This may result in other advantages which partly offset the increased cost of transportation and which require a careful analysis of an entire marketing program rather than a mere comparison of transportation costs alone. Such other advantages may include a wider area of operation, smaller inventories, reduced spoilage, elimination for the need of local warehousing in distant areas, lower packaging costs, and added sales value for products shipped by air.

These advantages are illustrated by a consideration of some of the important types of commodities shipped by air freight. A large proportion of air shipments has consisted of industrial equipment or repair parts for equipment or industrial installations. Speed is often of great importance in such shipments because quick availability of a part may prevent the shutdown of an entire factory. Furthermore, the manufacturer of such products does not need to maintain local stocks of repair parts in distant cities when he is able to make delivery within a day of receipt of an order. Highly perishable food products such as fruits and vegetables and fresh seafoods are another important category of air freight shipments. Strawberries, tomatoes, and live lobsters are illustrative of products that may be placed on sale in distant consuming centers with a much higher sales appeal because of the short length of time required for shipment. Packing costs are reduced because of more careful handling and the elimination of the need for protracted refrigeration protection. Women's high fashion apparel has also been shipped in considerable volume by air freight. Merchants in the West and South can now obtain garments from the New York market a day or two after the first appearance of a new fashion expression in place of the five to ten days ordinarily required for surface movement to distant cities.

Special Features of Our Transportation System

The manner in which our existing transportation system meets the major demands placed upon it by the normal requirements of marketing the products of a specialized economy has been discussed in the preceding sections of this chapter. There are, however, a number of additional special features of transportation that have been developed to facilitate economical and efficient marketing and to encourage more widespread consumption of certain commodities. Some of the most important of these features are

blanket freight rates, diversion in transit privilege, through or processing rates, and the use of pool cars. Each of these is given some consideration in the paragraphs that follow.

Terms of Sale Related to Transportation. The significance of transportation is reflected by the fact that many "terms of sale" are related to the assumption of the costs and risks associated with this function. Exact knowledge of many sales contracts is dependent upon a clear understanding of such terms. Some of these terms are quite complex and are used only under special circumstances or in certain industries. Others are quite common or are of such great importance that they merit some explanation at this point.

One of these terms is *f.o.b.,* which means that the seller is to place the commodity "free on board" the car, or at ship side (f.a.s.), at the point of shipment, that the buyer is to pay the freight and other charges, and is to assume all risks of damage in transit which are not caused by the seller or which are not covered by the liability of the carrier. Unless otherwise specified, f.o.b. sales are understood to mean sales at the shipping point at an agreed price to apply as of the date of sale, usually with inspection privileges at destination. "F.o.b. destination," "f.o.b. Chicago," and similar terms require that the seller assume all transportation costs and risks, for he has the responsibility for the delivery of the commodity to the point designated or implied in these terms. These are known as "delivered sales."

Large quantities of certain raw materials are sold on a *to arrive* basis. Terminal market wholesale grain dealers often send bid cards to assembly market elevators, offering to buy grain of certain grades at specified prices, providing shipment is made within a certain number of days, usually ranging from 10 to 30. Limitations are placed on the amount that will be purchased and on the time available for acceptance, which is often the day following receipt of bids by assembly market elevators. "To arrive" means that the seller pays the freight charges and that shipment will be made for arrival at the specified destination within the indicated time limit.

Certain other terms, including "in-transit sales" and "tramp car sales" are explained in connection with subsequent treatments of special features or privileges offered by our transportation system.

Class Rates and Commodity Rates. Most of the significant *special* features of our transportation system pertain to railroad freight shipments. An understanding of types of rail freight rates is a prerequisite to an appreciation of the special features that have been developed. Two basic kinds of rates are in general use: class rates and commodity rates. In order to simplify the problem of publishing rates for thousands of individual products moving between thousands of points of origin and destination, railroads group commodities of similar bulk, weight, value, perishability, or other

pertinent characteristics into classes, each of which has its own freight rate per 100 lbs. Thus, numerous commodities with approximately the same cost of handling and cost of movement take exactly the same class rate for any specified distance. Class rates are most important for shipments of manufactured goods and are employed by motor truck common carriers and freight forwarders in a manner similar to that used by railroads. Rates for any given class of freight vary with distance, but not directly so. They are relatively lower for long than for short hauls because terminal handling costs remain about the same for both. In order to make allowances for regional differences in the cost of transportation and the demand for it, various freight rate territories have been defined, known as the Eastern or Official, the Southern, the Western Trunk Line, the Southwestern, and the Mountain-Pacific. In each of these territories a different structure of class rates exists. Classification of specific commodities and determination of freight rate structure are the immediate responsibility of committees representing the railroads operating in each territory. Changes in product classifications and rates can be made, however, only after public formal hearings and approval of the Interstate Commerce Commission.[5]

Commodity rates are published rates that pertain to specific products being shipped between named points of origin and destination. Commodity rates have been developed for most of the heavy and bulky articles of commerce which move in large volume over the transportation system. They apply to practically all commodities shipped in bulk and also to many kinds of merchandise freight which ordinarily move in carload lots, especially where large distances are involved. Generally they are lower than the class rates that would apply to the product in the absence of commodity rates. Such rates are designed to permit maximum movement of basic commodities with consideration being given to the peculiar characteristics of individual commodities, production and consumption conditions, and the economic need for transporting them to distant regions. Like class rates, commodity rates are subject to approval of the Interstate Commerce Commission.

Blanket Rates. Commodity rates, which vary directly or indirectly with the distance involved in a shipment, often result in prohibitive transportation costs for long-distance shipments of heavy or bulky products. When such commodities involve large potential freight movements, blanket or "postage-stamp" rate systems are sometimes developed in order to encourage greater

[5] The practice of classification and rate determination involves numerous complexities that cannot be treated adequately within the space of this chapter. The student interested in a more detailed treatment may consult any of a number of excellent books on the subject of transportation. See, for example, Frank M. Cushman, *Transportation for Management* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1953), especially chaps. vi–ix; and, Truman C. Bigham and Merrill J. Roberts, *Transportation Principles and Problems* (New York: McGraw-Hill Book Company, Inc., 1952), especially chaps. xi–xvii.

distribution and consumption of the commodity in question. An important example is the case of California citrus fruit, the rate on which is the same to all points east of an arbitrary line drawn roughly north and south from Denver, Colorado. In the absence of such a rate, the freight charge would result in a price for the commodity which would be prohibitive to most consumers in Eastern cities, and the movement of the commodity to such cities would be accordingly discouraged, all in favor of competitive products from Florida. On the other hand, it is not believed that prices for the commodity would be appreciably lower in western and middlewestern states where consumers absorb a transportation charge somewhat higher than the actual cost of shipping to cities in these regions. Many other western fresh fruit products take a similar blanket rate. Another example is afforded by the transcontinental shipments of canned fruits and vegetables from Pacific coast regions. Many such products must be sold in competition with products canned in the Ohio-Indiana region, and for this reason a blanket rate has been developed applying to all shipments made to points east of Sydney, Nebraska, with the exception of the New England states, the North Atlantic states, and the Florida peninsula, which areas are respectively blanket rate zones with slightly higher rates. The grouping of a number of destinations in a large area has often contributed to decentralization of industry and wholesale trade. For example, all New England cities have been grouped for the purpose of blanket rates on a number of commodities originating at points west of Pennsylvania. The resulting equalization of raw material costs over the blanket rate area has favored the growth of industries in scattered smaller towns.

Diversion in Transit. The meaning and importance of the special privilege known as diversion in transit can be best explained by an illustration. It is frequently necessary to ship apples from the northwestern states to eastern markets before they have been sold. Such cars are said to be *rolled unsold.* It is hoped that they will be sold before they arrive at a major diversion point such as Minneapolis or Chicago. Hence they are consigned to the shipper himself at one of these points, and if sold while the car is still rolling, they will then be reconsigned to the purchaser at his receiving point. If a sale is not effected, the car of apples can be reconsigned to some other eastern or southern point such as Cleveland or Louisville, depending upon developing market conditions. If they are still unsold when they reach one of these points, the car can be again reconsigned to some other market. This can be repeated just as long as the shipments move in a forward direction. When the car is sold in markets which are in a direct line of haul from the point of origin, this is known as an *in-transit sale*. This is in contrast with a *tramp car* sale which is made to a purchaser in a market which is out of the line of haul from the originating point. For example, an eastbound car could not be

reconsigned from Chicago to Des Moines, Iowa, which involves back hauling, without paying the carrier the additional rate in force for shipment between these two points.

When goods are shipped under the diversion-in-transit privilege, price and terms of sale are fixed by telegraphic offers and acceptance. If satisfactory bids are not forthcoming, the goods are diverted to the most favorable market, judging from the latest market information that is available. All in-transit or tramp car sales relate back to the time of issuance of the bill of lading by the carrier. Usually the buyer pays the freight on such transactions, but he assumes only the lowest authorized freight charges applicable between the point of origin and the destination stipulated in the sales agreement. In the case of tramp car sales, the seller ordinarily assumes any transportation charges that are in excess of those that would have normally accrued if the shipment had been made direct.

The diversion-in-transit privilege is especially valuable for shippers of products which take a blanket or postage stamp freight rate. It is highly important also for shippers of products which cannot be stored and when the market in the city to which they were first consigned is temporarily unfavorable. The price of perishables often varies greatly in different cities on the same day, and it may be very much worth while to change the original idea as to the market in which a car of produce could be best sold and divert the car to a better market. It is sometimes necessary to stop a car of rapidly deteriorating perishables before it reaches its final destination. Representatives of the shipper can examine the produce and, by use of the diversion privilege, send it to a closer market. A small charge, amounting to a few dollars per car, is made for the additional accounting and other work caused to the railroad, but such a charge is far less than would be the rate to the new point. Diversion is also practiced in shipping coal to the West and lumber to the North and East. Crude ore is also diverted at times.

Through or Processing Rates. To facilitate the movement of basic raw materials from distant originating points to factory locations or processing plants which are between the originating points and consuming markets, railroads have developed another special privilege, that of through rates applying to commodities which are processed while in transit. Where this privilege exists, a commodity may be shipped from an originating point (A) to an intermediate point (B), where the commodity is subjected to some manufacturing or commercial processing, and then reshipped to a final destination (C) at a through rate which is less than the combination of the local rates from A to B and from B to C.

Through or processing rates tend to equalize the marketing advantages of competing industrial locations. For example, grain may be shipped from a grain market to an important flour milling center where it is ground into

flour and then reshipped to large consuming markets at the through rate applicable from the point of origin to the final destination of the finished product. In such a case, the local rate on grain is usually paid on the shipment from the point of origin to the milling location; and when the flour is shipped to the consuming market, it moves at the *transit balance* which is the difference between the rate on grain from the point of origin to the final destination and the amount which was actually paid on the shipment of grain from the origin to the milling point. This privilege equalizes transportation costs for all milling centers located between the grain originating areas and the consuming markets; and where the privilege exists, it allows variously situated producers to compete on equal terms with regard to this cost factor.

Through rates are not limited to manufacturing operations in transit. A number of other important applications may be mentioned. Cotton is often unloaded in a large city en route in order that it may be "classed" or graded by experts. Railroad ties are often unloaded and treated at creosoting plants. Texas cattle are fattened in the Middle West whence they proceed to livestock markets at a through rate. Western wool is scoured and graded at St. Louis, Chicago, and other points en route to the East. In these and in other similar situations, if the shipper were compelled to pay the total of two local rates, it would cost him considerably more than the through rate from the original shipping point to the final market. By taking advantage of the privilege of stopping his commodities for processing, manufacture, grading, or storage, he saves substantial amounts. A charge is ordinarily made for the exercise of the through rate privilege, but this is nominal in amount, covering only the additional clerical costs involved in accounting for such shipments. A time limit is usually set on shipments to final destination, but this may be as much as two years and does not represent a practical limitation to the use of the privilege.

Use of Pool Cars. The term "pool car" refers to a car containing commodities intended for two or more receivers. The plan is used for shipments of articles that would otherwise have to be forwarded under less than carload rates, which are always higher than rates applying to car lot shipments. Several variations of the plan may be found. If a washing machine manufacturer in Ohio desires to ship his product to dealers in Missouri and Kansas whose scale of business does not justify the purchase of a full carload of the merchandise, he can attach labels to each machine and ship a whole car to St. Louis or Kansas City, paying the carload rate to the point where the shipment is broken. The machines will then be delivered by the proper railroad to the consignees at l.c.l. rates for the remaining distance.

Pool cars may include commodities from more than one shipper. For example, three different manufacturers of machinery or equipment located in

the same industrial district in Pittsburgh may consolidate their respective shipments to Texas in a single car consigned to a receiver in Dallas. If such a car contains merchandise that falls into more than one freight rate class, it is known as a *mixed car*. Such shipments usually take the highest freight rate and the highest minimum carload weight applicable to any class of merchandise included in the mixture.

Commercial trucking companies frequently act as receivers for pool car shipments. They receive the car and then distribute its contents to dealers in the territories they serve, in accordance with instructions issued by the shipping company. Sometimes trucking companies give the impression that trucks so used are owned by the company whose products are being delivered, as they change the company name on the truck with each change in client. Any one of these plans enables certain shippers to sell in territories which could not otherwise be reached because of the prohibitive cost involved in less than carload rates.

Pool car shipments sometimes result from arrangements made by buyers rather than by sellers. Local retail merchants' associations have effected such arrangements in a number of cities. For example, in Columbus, Ohio, about 50 retail stores are members of an association that exists for the purpose of consolidating pool car shipments from New York City to Columbus. Each member store makes numerous purchases from New York City suppliers and, in the absence of pool cars, most of these would be shipped at l.c.l. or l.t.l. rates or by express or parcel post. All members of the group request New York area suppliers to deliver l.c.l. shipments to a consolidation agent in that city. Purchases for all stores are formed into pool cars which move by fast rail freight at c.l. rates to Columbus where they are delivered to individual members by a local trucking company. Such shipments averaged more than one pool car per day and resulted in transportation cost savings of more than $100,000 in 1955.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) demurrage fee
   b) place utility
   c) time utility
   d) piggy-back service
   e) freight forwarder
   f) class rates
   g) commodity rates
   h) blanket rates
   i) diversion in transit
   j) in-transit sale
   k) tramp car
   l) through or processing rates
   m) pool car
   n) mixed car
   o) f.o.b. terms of sale
   p) "to arrive" sales

2. How does an adequate transportation system contribute to economy in the creation of form utility?

3. How do the service requirements of merchandise freight differ from those of bulk freight? What freight service agencies are primarily or altogether bulk freight agencies? Which are primarily or altogether merchandise freight agencies?

4. How can the large differences between c.l. and l.c.l. rates be justified?

5. What special features of our transportation system have grown out of the differences between c.l. and l.c.l. rates? Explain.

6. Assume that you have just been employed as a sales representative for an air freight carrier and charged with the responsibility of soliciting business from agricultural shippers. What kinds of shippers would be good prospects for this type of service? If such prospects knew that air freight rates were several times as much as l.t.l. rates, what appeals could you use to interest them?

7. If you were the traffic manager for a large department store located in a major city in the New England states, and responsible for routing shipments on which your store paid the freight, explain how you would route each of the following shipments:

   a) A 400-lb. shipment of toys from New York City, not to be sold for several months
   b) An 80-lb. shipment of dresses, high fashion items, from New York City.
   c) A special order of a $250 evening gown, from New York, needed by a customer for a party tomorrow evening
   d) Six upholstered sofas, from North Carolina
   e) 40 lbs. of drapery material from West Virginia
   f) A 600-lb. shipment of fresh seafood for restaurant departments, from New Orleans
   g) A 20,000-lb. shipment of mattresses from a factory in Cincinnati

   Would your answers be different in any case if you were the manager of a store located in the Rocky Mountain states?

8. The Jones Electric Company, manufacturers of household appliances, is disturbed over the high cost of transporting its products to the many dealers it serves throughout the country. Carload lots are seldom shipped and l.c.l. rates are very high. A freight forwarder refused to handle their products because many of their shipments go to towns too small to make his services profitable. Increasing competition necessitates a reduction in transportation costs. Explain how this may be accomplished.

9. Explain how the marketing opportunities of certain kinds of agricultural producers or manufacturers would be much more restricted than they actually are if we did not have each of the following features:

   a) diversion in transit privilege
   b) blanket rates
   c) pool cars
   d) through or processing rates

10. What is the total volume of freight moved annually by our transportation system and what proportion of the total is accounted for by each major type of freight service agency? Do such figures fairly reflect the true importance of water transportation or of motor truck transportation? Explain.

23

STORAGE AND MARKETING

To preserve goods for future use is a pervasive human desire. Even in the dim and distant ages when man's food supply consisted of roots, grains, and fruits that grew wild, evidences are plentiful that some of this supply was preserved from the time of its maximum availability to times of greater need. Under modern conditions, storage is a major economic function which involves the utilization of substantial manpower and capital resources and which is of concern to all segments of our economic order. The ultimate consumer finds it necessary or convenient to purchase some goods in advance of need and to store them for future use. For the most part, however, he finds it more desirable to allow business institutions to provide this service for him. Consequently, retailers and wholesalers must carry substantial inventories in order to meet the normal requirements of trade. Manufacturers also store voluminous stocks of finished goods, raw materials, and semimanufactured articles. Agricultural producers store large quantities of goods on private farms, either for subsequent farm use, or until it is desired to send them to market. In addition to the storage of goods by those who own them, there exists a major institutional structure of specialized storage agencies that provide facilities which are utilized by others who find it more economical to employ outside services than to provide them on their own.

Reasons for Storage. The economic significance of the storage function can be better appreciated by preliminary attention to the various kinds of circumstances which give rise to the need for storage.

One major reason for storage is the necessity to meet *normal requirements of trade*. It is certainly not coincidental that most retail establishments are known as "stores," and that this term, differentially prefixed, is also sometimes used to describe the facilities of wholesaling organizations as, for ex-

ample, "wholesale store," although it is more common to refer to a wholesale establishment as a wholesale house or *warehouse*. Considerations of etymology suggest the deep-rooted but often overlooked basic character of mercantile organizations as storehouses of merchandise. Even under modern conditions where the flow of goods from form-utility production to consumption has been greatly accelerated by improved communication and transportation facilities, normal trade inventories involve staggering quantities.

Over the period 1951–55, inventories of all retail establishments have fluctuated between $21 and $24 billions at cost value and usually amount to the equivalent of about two months' sales (at cost value).[1] Inventories of wholesalers and certain other types of wholesale establishments included in the series are smaller than those of retailers in relation to their sales, but ordinarily represent about 1.5 months of such sales, and these ranged from about $11 to more than $12 billions during the period 1951–55. These inventories are needed to present merchandise in advance of actual sale, to protect against the risk of delayed deliveries, and to offer customers a variety for selection. During the years 1951–55, manufacturers' inventories have varied from about $42 to $46 billions of dollars, of which about 35 per cent usually represented finished goods ready for shipment from factories. Such inventories, like those of retailers and wholesalers, are held primarily to meet ordinary trade requirements. About 37 per cent of manufacturers' inventories usually consists of purchased raw materials or semi-manufactured goods which must be assembled and maintained in amounts adequate to forestall any interruption in manufacturing schedules. The remaining 28 per cent of manufacturers' inventories consists of work in process and is related most directly to form-utility production rather than to marketing.

A second major reason for storage is the *seasonal production of goods that are consumed continuously*. Farm products are generally produced in quantities during certain seasons and must be stored if consumption is to take place in other than the producing season or seasons. This applies not only to basic agricultural commodities that are stored in their original state, as in the case of eggs or grain, but also to manufactured goods which are processed from them as, for example, canned or frozen fruits and vegetables or refined beet sugar.

Third, storage is necessary for goods which are *produced regularly but which are purchased or used seasonally*. In order to manufacture economically with a reasonable uniform utilization of personnel and capital facilities, many factories that make seasonal goods are operated almost continuously.

[1] For all data on inventories used in this discussion, see *Business Statistics*, 1955 Edition, Supplement to the *Survey of Current Business*, pp. 17–18, 47, and 49; also see *Survey of Current Business*, February 1956, p. 10.

Garden tools, woolen blankets, straw hats, and holiday novelties are illustrative of items that are often stored for long periods for this reason.

Fourth, storage is often essential *in connection with transportation arrangements.* Goods are stored at the point of shipment until an economical quantity is accumulated or until transportation facilities become available. This need is frequently related to seasonality in certain transportation facilities. For example, iron ore, limestone rock, and similar products from the upper Lake region are brought down the Great Lakes during the season of open navigation and stored in quantities at the lower Lake ports for use during the winter months when water transportation is impossible.

A fifth requirement for storage is for *conditioning purposes.* Tobacco, cheese, and meats are illustrative of commodities which are stored for purposes of curing. Distilled spirits are notable for their aging requirements. Bananas need ripening, and the same applies to tomatoes, cantaloupes, and other commodities that are harvested green. The seasoning of lumber is an excellent illustration of the need for storage for the purpose of retaining or improving the quality of the product.

Sixth, *speculation* in anticipation of favorable price fluctuations is often a reason for storage. Market conditions may be unfavorable at the time goods become available for sale, or the possibilities for increased prices may justify holding a product for later disposal. This may be purely speculative or incidental to the performance of merchandising functions. The first case is illustrated by the activities of professional speculators who specialize in the assumption of risks incident to buying and selling in accordance with price fluctuations. The second case is illustrated by the activities of many bona fide merchants who buy in abnormally large quantities when a rise in price is impending.

Seventh, one basis for much storage activity is *public policy.* This has been especially important in terms of the federal agricultural price support program. Under the Agricultural Act of 1954, prices of storable basic commodities are supported by loans which are guaranteed by the Commodity Credit Corporation. Instead of selling commodities such as grain, cotton, or tobacco, the farmer *may* obtain a loan at the value level at which prices are being supported as a matter of public policy. If the price drops below the official support level, the farmer can turn the commodity over to the Commodity Credit Corporation rather than repay the loan. Such commodities may be stored privately on farms, if the facilities are inspected, approved, and sealed by an official inspector, or they may be stored in public warehouses and the loans secured by warehouse receipts. In addition to price support loans, the Agricultural Act of 1954 also provides for "set-asides," to remove the threat of farm surpluses from current markets. The Secretary of Agriculture is authorized to set aside maximum inventories of a number of commodities, as follows: wheat, 500,000,000 bushels; cotton,

4,000,000 bales; cottonseed oil, 500,000,000 pounds; butter, 200,000,000 pounds; nonfat dry milk solids, 300,000,000 pounds; and cheese, 150,000,-000 pounds. When surplus commodities are withdrawn from the current market, they are not to be returned to it in any normal marketing operations that may influence current market prices, but are used in other constructive ways as in connection with school lunch programs, disaster relief aid to the people of other countries, and as stockpiled reserves for domestic use in time of war or other national emergency. Public policy of this kind has resulted in a great expansion of storage requirements for basic farm commodities.

The Economic Function of Storage. From the foregoing it is apparent that the principal and perhaps the only function of storage is the creation of *time utility*. This is accomplished when storage is used to preserve or keep goods from the time they are grown, mined, or manufactured until they are needed or used for consumption, thereby offsetting the effects of seasonal alterations of supply and demand and adjusting the difference of time between form-utility production and consumption. Under such circumstances storage acts like a reservoir, receiving the surplus flow of goods when form-utility production exceeds demand and releasing it when scarcity is impending. The creation of time utility is accomplished again when storage is used to permit the seasoning, ripening, aging, and curing of goods in preparation for the market. It is further accomplished when goods are stored in wholesale warehouses and in retail stores in order that they may flow freely through the channels of trade, in obedience to requirements, with a sufficient reserve to ensure continuity of such a flow. Finally, it is accomplished when storage is used in connection with the transportation of goods from places of plenty to those of scarcity. Here the storage service is emphasized by the special equipment used, including refrigerator and heater cars on railroads, special tank cars and tank trucks, and other special devices intended to preserve or properly care for the products transported. It is further emphasized by the carriers' provision for temporary storage of goods at points of shipment and destination.

Types of Storage

To serve the varying needs of trade a number of types of storage facilities have been developed. These may be *operated privately* by the institutions that own the inventories stored in the different types of facilities, or by *public warehousemen* who accept merchandise or bulk commodities from the general public, including businesses, for storage in a manner similar to the operation of common carriers in the field of transportation.

Yard and Ground Storage. Commodities which are not likely to deteriorate when exposed to varying weather conditions usually are kept in open air storage, commonly designated as yard and ground storage. This method is used for such bulk materials as coal, lumber, ore, gravel, sand, crushed stone, brick, sewer pipe, cooperage stock, barreled and casked goods of all kinds, pig iron, steel, paving materials, and numerous other commodities.

Ordinary Merchandise Warehousing. Probably the commonest type of storage is that generally known as ordinary warehousing. This involves the storage of merchandise under shelter and not exposed to weather. Stocks are held on the shelves, in the bins, or upon open floor spaces in establishments operated by retailers, wholesalers, manufacturers, and in numerous independent warehouses known as *public merchandise warehouses* and discussed subsequently in this chapter.

Great strides in marketing efficiency have been achieved in the field of ordinary warehousing in the years following World War II. Prior to this time, most merchandise warehouses, whether operated by department stores, chain store companies, wholesalers, or public warehousemen, were located in the central, congested areas of cities. Because of high real estate values, it was more economical to obtain adequate space through the construction of multistory warehouse buildings. At the same time. this brought about high costs of handling, largely because of external traffic congestion and the difficulty of *internal vertical* movements of merchandise. Newer warehouses have been constructed mostly in outlying areas, where sufficient ground space could be obtained at reasonable cost to permit the construction of single-story structures. This has resulted in a streamlining of warehouse operations by confining merchandise movements to a *horizontal flow* from receiving docks to shipping facilities and by permitting the use of various types of modern materials handling equipment that accomplish internal merchandise movements with very much lower labor costs than were formerly incurred in multistory buildings.

Special Commodity Warehousing. Special purpose warehousing facilities have been developed for the storage of the more important staple agricultural commodities. Illustrative are terminal grain elevators and cotton, tobacco, and wool warehouses, each of which is fitted to handle only one particular commodity. In contrast with ordinary merchandise warehouses, which usually serve as distribution or dispersion facilities, special commodity warehouses ordinarily function as concentrating points at which are gathered goods from numerous scattered producers and where a centralized supply of a relatively homogeneous commodity is held. Such warehouses often perform auxiliary services like grading, cleaning, compressing, and aging. As is explained in Chapter 28, most organized trading in futures

contracts for standardized agricultural commodities is based upon delivery of specified grades from approved special commodity warehouses.

Bonded Warehouse Service. Some ordinary public warehouses and certain special commodity warehouses are bonded by the U. S. Treasury Department to provide a special storage service which is of great significance in two types of situations. One is the distribution of imported goods on which customs taxes must be paid, and the other is the distribution of products such as tobacco and distilled spirits on which an internal revenue tax must be paid. Imported merchandise may be placed in storage in bonded warehouses in port cities upon receipt in this country. Customs duties do not have to be paid until they are actually withdrawn for domestic distribution. Similarly, internal revenue taxes upon tobacco and alcohol beverages do not have to be paid until such merchandise is released from a bonded warehouse. A bonded warehouse must be a separate building or a completely segregated and partitioned area within a building. A substantial surety bond is required of warehousing organizations with "bonded space" and a representative of the Treasury Department has actual custody of the goods stored in such areas. By storing in bonded warehouses, the depositor can use warehouse receipts for collateral in securing loans but may yet defer payment of substantial taxes until the goods are actually sold.

Cold Storage. Another type of warehousing consists of cold storage which is of significance chiefly for perishable food products. This type of storage may be private or public, although more than 85 per cent of the total refrigerated storage capacity is accounted for by public cold storage facilities.

Several classes of goods require the use of cold storage facilities. First, there are highly perishable fresh foods which, because of their extreme delicacy, cannot be preserved for any length of time. Refrigeration in transit or in the cooler space of the facilities of wholesale market middlemen usually covers the entire cold storage life of products such as fresh berries, peaches, grapes, plums, and melons. A second class consists of semi-perishable products which suffer no impairment when stored under careful cooling and appropriate conditions for periods of weeks or months. Among the common examples are apples, citrus fruits, various meat products, eggs, and butter. Adequate storage facilities for such products greatly prolong the marketing season for them. A third classification consists of frozen foods, which have greatly increased in importance since the 1940's. By the early 1950's, approximately 40 per cent of the total refrigerated storage space in the United States was freezer space, devoted to the storage of frozen fruits, vegetables, fruit and other juices, meats, and seafood products.

Cold storage is the most complex type of storage. Proper preservation of commodities under refrigeration involves various technical or scientific considerations. The length of storage life of many perishable products

depends not only on proper temperature and humidity conditions, but also upon the prompt removal of heat (or precooling) immediately after harvest. Provision must be made for removal of carbon dioxide which is continuously generated by fruits and vegetable and other living organisms. Each individual commodity has its own peculiar requirements, and, consequently, much study and experimentation has been devoted to the problem of developing ideal storage temperatures and other conditions.

The complicated character of cold storage has led many states to enact legislation to control this activity in the interest of public safety and welfare. The principal provisions of such laws relate to the temperatures which must be maintained for different foods and the maximum time for storing each. Further provisions require that all goods must be tagged or marked with the date of receipt, make it unlawful to return goods to storage after being removed, regulate inspection at time of receipt and during the period of storage, and, in some states, require that certain reports of goods in storage must be filed with state officials.

While most cold storage facilities are used for food products, certain other commodities are often held in cold storage. As a protection against moths and beetles, furs, rugs, and some finely upholstered furniture are often kept at low temperatures. Nursery stock, bulbs, paste and mucilage are other products which are often kept in cold storage in certain parts of the country or during certain seasons of the year.

Distribution of Goods Through Public Merchandise Warehouses

While all the types of storage discussed in the preceding section are of great importance, public merchandise warehouses are of unusual interest and significance because of the wide variety of purposes for which they are used. The character of their services and the marketing implications of distribution through such facilities are examined in the following paragraphs.

Marketing Services of Public Merchandise Warehouses. Public merchandise warehouses are institutions that *perform functions of physical supply* for miscellaneous and varied commodities which do not require refrigeration or other unusual facilities for protection or handling of goods. Their principal services are the following:

Storage. Storage is, of course, the major service. The hundreds of public merchandise warehouses, located in all significant distributing centers, provide facilities at which manufacturers or wholesalers may store semi-manufactured goods or finished products until the time that they are needed for distribution to the industrial market or to the ultimate consumer market.

Reshipping. Another general service is that of receiving large quantity shipments which are divided into smaller lots for reshipment. Carload lots of merchandise are often consigned to warehouses, with instructions to deliver the contents to various customers in accordance with a list furnished by the vendor. These goods may never be stored but are assorted on the platform and delivered locally or reshipped to outlying districts. The purposes of this service are to effect savings in freight charges on carload shipments and to expedite the movement of goods. Less-than-carload lots are usually more exposed to damage and pilferage than goods carried in car lots. Freight rates are considerably higher on the former and delays more common. Many warehousemen not only act as distributors of pool cars consigned to them, but even solicit, at certain centers, such as Chicago and Kansas City, small shipments which they themselves combine into "pool cars." These pool cars then go in unbroken bulk to a single town or to a certain junction or rate-breaking point where the contents are forwarded by another warehouseman to their proper destination. This practice is very similar to the service of the freight forwarding companies.

Order Filling. A third form of distribution service consists in filling orders from stock kept in storage. Under such circumstances, it is not unusual for warehousemen to extend credit to reliable purchasers listed with them by the vendor on an approved or "accredited" list and to render invoices, one copy of which is sent to the owner of the goods. The owner thus has daily knowledge of the quantity of goods on hand at the warehouse. Normally, however, orders from customers are submitted to the vendor who in turn instructs the nearest warehouse to make delivery directly to the customers in question.

Office and Display Space. Many warehouses provide office rooms and display space which may be leased by manufacturers who desire to have a company representative located in the same place as its stock of goods. This places the vendor in an advantageous position with regard to control of inventories and intimate knowledge of the marketing situations in various areas where warehouses are used.

Financing Service. When goods are to be held in storage for an appreciable length of time, they may be financed by means of warehouse receipts, issued by the public warehouse, which are used as collateral for bank loans. The relationship of public storage to market financing is discussed in a subsequent section of the chapter.

Other Services. Many public warehouses have facilities for receiving merchandise in bulk and packaging it in cartons or containers according to the owner's specifications. Shipment in bulk to consuming markets in this way often results in substantial transportation economies. Another serv-

ice is fumigation which is required by government regulations on certain types of cargo or freight. This is particularly important in connection with imported merchandise. Finally, the public warehouse, being a large-scale specialist in physical handling of products, is able to provide all sorts of the most modern types of equipment for the efficient loading and unloading of various kinds of goods received from ships, railroad cars, trucks, and planes.

Reasons for Sale Through Warehouses. From the foregoing, several reasons are apparent that explain why many manufacturers distribute their products through public merchandise warehouses. One reason for this practice is the desire of a manufacturer to ship his goods as far as possible in carload units. Another explanation is the desire of manufacturers to make their products conveniently available for delivery to local jobbers or retailers, without the necessity of establishing branch houses. This enables them to take full advantage of all sales opportunities resulting from their advertising and selling efforts. The storage company may even be mentioned in the advertisements as the distributing agency of the manufacturer. There is a growing tendency on the part of retail merchants to purchase goods in small quantities and thus increase their rate of stock turnover. The storage function is consequently passed on to the wholesalers and manufacturers. These find it necessary to carry adequate supplies in reserve at all times for the purpose of supplying the needs of customers without undue delay. It has therefore become the policy of many manufacturers to maintain such reserve or "spot" stocks in warehouses located at strategic centers of distribution.

A third reason is that the hundreds of public warehouses located in principal cities throughout the country provide an economical and flexible substitute for manufacturers' branches. A contract entered into with a warehouse for distribution service involves no outlay of capital and no obligations for a lease that results in continuing fixed costs. The amount of space used in a warehouse may be expanded or contracted as warranted, and the storage charge for a particular period of time is based only upon the amount of space actually used. Additional charges are made by the warehouse for handling merchandise in and out of storage and for local deliveries, but these are based upon the units of service actually rendered and do not involve any fixed items of payroll cost as experienced by manufacturers privately storing in their own branch establishments. Finally, this method is flexible from the standpoint that additional spot stock locations can be secured immediately and existing locations can be discontinued promptly when the need for them no longer exists.

Effect of Distribution Through Warehouses. The distribution service which is so commonly rendered by warehouses has tended to increase the

territory of operation of many manufacturers who, without it, could not afford to reach distant sections of the market. It has also brought about some changes in channels of distribution. It has enabled manufacturers to distribute their goods directly to retailers by substituting the warehouseman and his limited service for the wholesaler. Such a tendency is to be found in the marketing of specialties, patented goods, and advertised merchandise. These goods require nation-wide and aggressive distribution, which in some instances cannot be secured through the wholesaler. Direct selling, however, necessitates also direct and immediate delivery. In this connection the public warehouse becomes a potent factor. At the same time, the use of public merchandise warehouses by manufacturers has resulted in a multiplication of outlets and in extensive rather than intensive territorial cultivation, a policy the value of which may be questioned. Furthermore, when highly specialized technical knowledge or skill is required in filling orders or in the performance of the other services hereinbefore described, distribution through merchandise warehouses is not feasible nor advisable.

Storage and Finance

Standardized raw materials, agricultural consumer products, and manufactured goods in storage, if placed in the custody of a *public* special commodity, merchandise, or cold storage warehouse, are not necessarily dead value until the time that they are sold. Goods so stored are, on the contrary, an important basis for financing; and the growing popularity of supplying working capital in this manner has been an important factor contributing to the development of the public warehousing industry.

The Warehouse Receipt. As a basis for financing, the warehouse receipt has become recognized as valid security acceptable to all banks. It virtually converts stored goods into liquid assets, often necessary for credit purposes. Goods stored in a public warehouse become segregated from the owner's inventory and at once assume a distinctive and enhanced value as collateral, for they now rest under the guardianship of a reliable storage company. This is due in part to the beneficial effect of storage upon risks. All modern warehouses are of good construction and are usually fully equipped with sprinkler systems which are carefully watched at all times. Special low rates are consequently quoted by insurance companies on goods stored in such buildings. Other hazards incident to physical deterioration are similarly reduced because of the expert attention of specialists to problems of pest control, ventilation, and proper stacking.

When readily marketable goods are placed in a public warehouse, the owner may receive a *negotiable* warehouse receipt executed in his name and which he may endorse to the order of his bank, or he may obtain a *non-*

negotiable receipt issued originally in the name of his bank. Either type of receipt is regarded as sound collateral for bank financing. Loans amounting to 60 or 70 per cent of the market value of the merchandise are often made on the basis of such security. Until the loan is repaid, the borrower cannot regain possession of the merchandise. If the loan is defaulted, the bank can claim the merchandise and have it sold to satisfy the obligation. When the borrower wishes to make a partial withdrawal of the merchandise which is so pledged, arrangements can easily be made to repay part of the loan or to pledge additional security of an equally satisfactory character.

Field Warehousing. A natural development of the principle of using warehouse receipts as collateral for bank loans is what is known as *field warehousing*. Although supported by a decision of the United States Supreme Court as early as 1904, the method did not come into general use until the early days of the depression of the 1930's when needs for additional capital and the inability or unwillingness of many banks to extend normal credit lines gave impetus to its development.

The idea is simply that warehouse receipts normally issued on goods stored in a public warehouse shall be made available for financing the storage of merchandise on the premises of the manufacturer or whoever owns the goods. The warehouse is in effect moved to the owner's plant or warehouse. The owner of the goods actually leases a portion of his storage facilities to a licensed warehouseman who places a representative in charge, posts signs stating that a designated portion of the warehouse is in charge of the outside organization, and adds to or takes from stock as directed by the banker who has the stock as collateral. The field warehouse representative may actually be a regular employee of the owner of the pledged inventory, but must be covered by a fidelity bond commensurate with the degree of financial responsibility involved. Under this arrangement, such a representative can continue with the performance of his normal responsibilities, so that there is very small personnel expense connected with the warehousing. Field warehousing is thus, in reality, more of a credit arrangement than a strictly storage operation. Experience has shown that collateral so warehoused is just as secure as when it is placed in a public warehouse.[2]

Typical illustrations of the plan in use are manifold. A paint manufacturer found himself with an overstock. Three options existed. He could cut the price, take a large loss, and perhaps move it into the market. He could deposit the merchandise in a public warehouse and borrow on it, but that

[2] Certain difficulties are, however, recognized in connection with abuses of the plan. In general, they arise from failure properly to segregate the materials warehoused and in looseness in allowing pledged commodities to be taken from field warehouses without authorized release. These are merely violations of the basic principles of good public warehousing which differ in no important particular when applied to field warehouses.

was too expensive. The third plan, that of assigning a part of the stock to a field warehouseman, was adopted with success and economy. Manufacturers of tin cans store them in canners' warehouses until they are needed by the canner, when he makes the required payment before they are released by the manufacturer. He thus reduces the time for his loans to a few days, for as soon as they are filled they become the basis of another loan, as they can be at once turned over to the same field warehouseman who had them while they were empty. A steel pipe manufacturer has used the plan for carrying reserve stocks in three widely scattered cities. Farm implement manufacturers find it equally useful. In fact, any manufacturer who produces a standard product in ready demand can use the plan for additional financing.

Field warehousing arrangements can be worked out by manufacturers in connection with goods stored by wholesale distributors. For example, a manufacturer of air conditioning equipment experienced a great increase in sales over a five-year period. This made it necessary to manufacture units long in advance of the peak selling season. The accumulation of large inventories overtaxed the manufacturer's storage space and the expense of holding such stocks drained his working capital. Arrangements were made to ship completed units to the company's major distributors in different parts of the country, and the goods were placed in storage in the distributors' warehouses under a field warehousing plan. Warehouse receipts were obtained for the goods held in custody of the warehousing firm and used as collateral for economical bank financing. When the peak selling season arrived, the units were sold to the distributors and the field warehousing arrangement was terminated. Distributors were granted discounts to compensate them for performing the storage function and the manufacturer was saved the expense of a double handling and movement of the goods.

The advantages of field warehousing are several. First, it is economical, since it is unnecessary to move the stock to a public warehouse for deposit. Liquids can be left in their natural containers, cans of food need not be cased or labeled until their buyer is determined and is ready to pay for them, and in some cases goods to be further processed can be left adjacent to their next step of production, thus eliminating the two-way trip to a public warehouse. Second, banks are ready to quote a lower rate of interest on loans so secured than on loans based on an open line of credit, for the notes can be rediscounted with a reserve bank. Third, if the manufacturer cannot be supplied with funds locally, paper secured by field warehouse receipts can be more readily sold in a nation-wide commercial paper market.[3]

[3] Some of the companies engaging in field warehousing combine this service with regular public warehousing. Others are engaged in field warehousing exclusively. A limited number of companies account for most of the financing handled in this man-

The principal limitation is the cost of arranging for field warehousing services. Service fees must be charged to cover the cost of segregating the warehouse area involved, providing locks and signs, bonding a warehouse representative, and making periodic audits of goods held in storage. Such charges are relatively small when inventories of large value are involved but are prohibitive in connection with very small-scale financing. The minimum loan which is considered economically practical for a field warehousing company to handle is about $10,000.[4]

General Aspects of the Storage Function

Relation of Storage to Other Marketing Functions. Storage exercises a profound influence on all the marketing functions. It facilitates buying and selling, inasmuch as it produces a greater mobility of goods. This may be accomplished by transferring title without actual physical delivery of the merchandise and by warehousing at widely scattered trade centers from which goods may be delivered to customers without delay. Improved methods of storing in refrigerator or heater cars incidental to the creation of place utility have made possible the transportation of perishable and semiperishable commodities to distant markets, thus greatly broadening the market for many goods. Pineapples can now be transported from Cuba to all parts of the United States, as can cantaloupes from Colorado, the Georgia peach crop, and innumerable other products. Furthermore, modern storage reduces freight charges, for the public warehouse provides a center for breaking carload shipments for distribution among customers in accordance with instructions from the consignor. The important relationship between storage and market finance has been indicated at some length in the preceding discussion. This relationship has encouraged greater standardization of commodities, because larger loans can ordinarily be secured on standardized goods which have an ascertainable market value and which can be described exactly in a warehouse receipt. Adequate storage facilities also tend to minimize market risks on many commodities.

Storage and Prices. One of the most important influences of storage is that exerted on prices. This influence may be observed in connection with

ner. The largest is Lawrence Warehouse Co. which has offices in principal cities in all parts of the country. Other important companies are Douglas-Guardian Warehouse Corp., New Orleans; St. Paul Terminal Warehouse Co., St. Paul; St. Louis Terminal Warehouse Co., St. Louis; Banks Warehouse Co., Chicago; and Tidewater Field Warehouses, Inc., Philadelphia. Some of these organizations also have a number of branch offices in various cities.

[4] Louis A. Benoist, "How Field Warehousing Concerns Help Small Business," U. S. Department of Commerce, *Management Aids for Small Manufacturers*, December, 1954, p. 3.

seasonal and cyclical fluctuations as well as with respect to long-run price relationships.

Seasonal Fluctuations. By making it possible to hold surplus products from periods of abundance to times of scarcity, storage helps in stabilizing prices throughout the year or season, as the case may be. In the absence of storage facilities, there would be market gluts at certain times and inadequate supplies at others. Prices would consequently be so depressed during the former stages as to make them unremunerative to vendors and so high during periods of scarcity as to make the product prohibitive to the majority of consumers. Storage, on the other hand, stimulates the initial price to the producer, for the purchases made by speculators and dealers during periods of abundance in anticipation of later and greater needs prevent prices from falling as low as they otherwise would. Similarly, when the fresh supply of products is greatly reduced and prices commence to rise, the stored supply of these products is released in such quantities as to prevent the prices from soaring and to regulate consumption as warranted by the conditions of actual supply. Eggs furnish an excellent example of just such a situation. Any study of prices of the commodity prevailing at different seasons of the year will at once reveal the fact that the fluctuation in prices throughout the year has been considerably reduced by storage. Not only are seasonal shortages and gluts evened out by storage, but it exercises a similar influence upon temporary conditions. Sellers find it unnecessary, with the exception of a few of the most perishable products, to dump their goods on the market and suffer unnecessary losses. Both prices and consumption are made more uniform than they were before cold storage facilities were as well developed as at present.

Cyclical Influences. The cyclical relationship between adequate storage facilities and prices is similar to the seasonal effects just described. It is, however, confined to commodities of a relatively nonperishable nature. Cotton, wool, grain, and tobacco are excellent examples of commodities which are often held in storage for several years. Owners of such commodities have the opportunity of holding commodities off the market for relatively long periods if current prices are discouraging. The possibility of storing commodities in years when there is an abundant supply resulting in low prices and the possibility of consuming from accumulated inventories in other years when demand is high in relationship to current production tends to minimize cyclical fluctuations in the price level.

Long-run Effects. Storage also exhibits a tendency, in the long run, to lower prices. It prevents waste by adjusting the difference between the time and place of production and consumption. Moreover, by reducing producers' risks, it tends to stimulate production. The net effect is to increase the total

available supply of goods, which, in the absence of changed conditions of demand, would tend to reduce prices to the ultimate consumer below what they would have been in the absence of storage and enable him to maintain his standard of living in the face of changes in seasons. The possibility of storing all surplus products encourages the production of goods, including even perishables which now can be stored for relatively long periods. To this may be added the reduced costs of marketing, resulting from proper storage, the effect of which is to lower prices to the consumer and to narrow margins on which middlemen can now handle such goods. Incidentally, inasmuch as storage can best be used for products of relatively high quality, the effect is to encourage production of better quality merchandise that can be readily graded or otherwise standardized.

It should be cautioned that storage is only one of a number of complex factors influencing the price structure. For this reason, actual movements in the price level for a particular commodity are not always those that would be expected according to the foregoing analysis. When storage does not result in observable results as stated, it is because other factors not related to a more stable supply have operated in a manner to offset the influence of storage. Demand, for example, may have greatly increased in relation to existing supply, or general inflationary or deflationary trends may have influenced the price of all commodities. Finally, it should be observed that the influence of storage on prices is most marked for agricultural commodities. It is not of the same relative importance for finished manufactured goods, the current production of which can be more closely attuned to existing market demand. Storage does, however, influence production costs and prices in manufacturing industries by overcoming seasonal production problems. The possibility of accumulating inventories consumed seasonally promotes continuous operation and tends to iron out costly irregularities in manufacturing and processing. Another important benefit incidental to this service is greater regularity of employment for the labor engaged in manufacturing.

Need for Regulation of Storage. Abuses of warehousing services are not unknown. Storage, for example, may encourage speculation of an undesirable nature. It makes possible some centralized control of food supplies and concerted action to keep merchandise out of the market as an instrument for enhancing prices. Unscrupulous individuals have at various times attempted to circulate false rumors concerning conditions of supply of stored goods in order to influence prices for their own immediate benefit. There have been instances where food was held in cold storage for speculative purposes and dumped on the market after it became unfit for human consumption. It is still not uncommon to sell storage goods as fresh. Although

storage goods may be as good as fresh merchandise, the practice involves a misrepresentation that is highly undesirable.

Warehousing Acts. To remedy these and other abuses arising out of the storage of goods, both state and federal governments have attempted to regulate and control our storage facilities within certain limits and in varying degrees. The United States Warehouse Act of 1916, for example, has greatly improved the value of warehouse receipts. It provides for the licensing and bonding of warehousemen and subjects them to inspection and supervision designed to establish the integrity of the receipts issued. Licenses are intended to be issued only to warehouse companies which possess net assets comparable to their volume of business and whose business standing is of good repute from the standpoint of management, practices, and equipment. The law applies only to warehouses engaged in the storing of agricultural products entering interstate or foreign commerce.

All forty-eight states have enacted Uniform Warehouse Receipts Acts. These laws are similar in purpose to the United States Warehouse Act but are broader in scope in that they apply to all forms of public warehousing—not just to agricultural commodities. The law defines a warehouseman as "a person lawfully engaged in the business of storing goods for profit." It defines the warehouseman's liability and the nature and extent of his lien on the goods and makes possible a complete identification of the warehouse receipt with the goods it represents. Moreover, it renders such goods immune to attachment; gives full negotiability to the receipt which is completely assignable if it reads "to order," except where it falls into improper possession; and relieves the endorser from guaranteeing either previous endorsers or the integrity of the warehouseman.

While such laws are of a constructive character, it is often claimed that they do not provide adequate control. The federal law, as has been explained, applies only to agricultural storage facilities and it is *optional* rather than mandatory. This means that a warehouseman may become licensed under the regulation but there is no requirement for him to do so. Most large storage companies dealing in agricultural commodities are licensed, but many smaller ones are not. Many agricultural producers are not informed about the degree of protection afforded to them by the licensing program and sometimes suffer from abuses by nonlicensed operators. The state laws, it is often alleged, are more of a protection to the warehousing industry than to the storing public. They deal chiefly with limitations upon the warehouseman's liability and with the character of warehouse receipts. Agricultural groups have pressed for stronger controls to insure that the owner of goods may store them in public facilities with the assurance that he can obtain the same products whenever desired, or obtain goods of like quality and grade in the case of commingled commodities such as grain. While most public ware-

houses are highly reputable organizations and pose no problem of control, stronger measures are sought to protect the owner against a limited number of less scrupulous operators.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   a) storage
   b) warehousing
   c) time utility
   d) bonded warehouse service
   e) ordinary warehousing
   f) field warehousing
   g) public merchandise warehouses
   h) special commodity warehouses
   i) yard and ground storage
2. When an economist says that storage is production, what does he mean?
3. It is often said that, in the long run, consumers pay all costs involved in manufacturing and marketing. If this is true, will the expansion of the storage function bring about lower prices to consumers? Explain fully.
4. Is there any significance in the fact that a retail establishment is known as a "store" and that the term "store" is also often applied to a wholesale place of business with the prefix "wholesale"?
5. Among the various commodities stored in large quantities are farm products. How can this fact be explained? Does the same explanation apply to meats? To lumber? To woolen blankets?
6. Would you classify warehouses as marketing institutions? Explain.
7. When the services of public merchandise warehouses are carefully analyzed, does this suggest the probability that these institutions will supplant the wholesaler as a marketing institution? Explain.
8. As a manager of a newly established public warehouse, you are drawing up a booklet for issuance to manufacturers in the regions you serve. Outline the advantages which the manufacturer may derive from using your storage facilities.
9. Indicate the short-time, cyclical, and long-run or secular effects of storage on prices. What is the explanation?
10. For several years, a manufacturer of automobile tires has maintained branch warehouses in five large western cities. Economic conditions reflect a downswing in business activity. Financial capacity is limited. Under the circumstances it is felt that the company cannot carry the heavy financial burden of these five warehouses. Three of the branch warehouses are owned outright by the company; in the other two cases, the building and attached facilities are leased. The manufacturer does not want to give up these territories. How can he continue to serve these areas without the heavy investment in reserve stocks and equipment? Outline a solution.
11. John Smith is engaged in the manufacture of a standard grade of woolen gloves which are used chiefly during fall and winter months. Smith's financial condition is not too strong, but he wishes to operate his plant the year round if possible. Explain and evaluate storage methods available to Smith in accomplishing his objective.

12. The Myers Petroleum Company is a bulk tank distributing organization that owns a facility consisting of six large bulk storage tanks. Most of its business consists of fuel oil sales for industrial or household heating purposes. Sales are made direct to users, and fuel oil is delivered into the users' storage tanks by the company's bulk trucks. Because of seasonal requirements, the company must stock heavily during the summer months so that it will be in a position to make large-scale deliveries during the early part of the cold weather season. This necessitates paying petroleum refiners far in advance of the receipt of income from sales to customers. It is now spring and the company officers are formulating plans for the coming season. Much new home building is in progress. Because of a lack of cheap manufactured or natural gas, most new homes are constructed in this area with fuel oil furnaces. During recent weeks there has been much informed trade talk about price increases in the fuel oil industry during the late summer. Because of these reasons, it is considered advisable to accumulate as much inventory as can be stored early in the summer. The Company is not in strong financial position and does not believe it can obtain additional credit from its suppliers.

    What means may be used to finance the inventory? Explain how arrangements could be made for this purpose and what advantages would be associated with the appropriate form of financing.

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STANDARDIZATION AND MARKETING

An important part of the marketing process is the determination of the shape or form in which a product is to be placed on the market. Consequently, some of the most vital marketing problems center around the activity of establishing and maintaining standards and providing for conformity to them. Standards may be concerned with nomenclature, methods of test or inspection, methods of rating machinery, rules of operation and procedure, rules of safety, and many other such considerations. Of greatest significance to marketing operations are standards that relate to the physical properties of commodities. It is with these types of standards that the discussion in this chapter is mainly concerned.

The Meaning of Standardization. A *standard* is a measure that is generally recognized as having a fixed value. *Standardization,* then, involves the determination of basic measures or limits to which articles being standardized must conform and includes the process of conforming to such standards. *Simplification,* on the other hand, deals with the elimination of superfluous varieties. Paint brushes, for example, may be standardized by agreement that only certain standard widths and thicknesses shall be manufactured and that there shall be certain methods of attaching the handles to the bristles of the brush. They may be further standardized by agreements touching the quality of the bristles. Simplification, however, would involve a reduction in the number of sizes to be manufactured or in the different qualities of bristles used.

Grading is in reality a part of standardization. It is a process which tests the conformity of commodities to standards that have been previously set up. There are thirteen official grades of cotton in common use in the

American cotton markets. Grading of cotton, therefore, involves the examination of individual samples to determine to which one of the thirteen grades the cotton under consideration belongs.

Standards may be *general* or *private*. General standards are those which relate to all similar commodities no matter who produces them. Products of agriculture and the extractive industries are usually graded according to general standards. Standards are private when individual limits or measurements are set up by particular manufacturers or merchants or by those who purchase products for use or resale. It is in the field of manufactured goods that private standards are of greatest importance. The physical dimensions generally understood by the designation "size 9½ B" when applied to men's shoes is a general industry standard, but the specifications as to quality of leather or thickness of sole as determined by a particular manufacturer producing a given style of shoes is an example of a private standard.

Responsibility for standardization within manufacturing companies may involve the manufacturing department, the marketing department, or both. When standards are primarily concerned with manufacturing cost savings, technique of manufacture, interchangeability on assembly lines, and utilization of existing patterns or designs, they are primarily the concern of manufacturing executives. On the other hand, when they relate primarily to the needs and requirements of customers, the efficient physical handling of goods in the distribution process, or to the employment of more efficient methods of sale, responsibility usually lies with marketing executives. Obviously, many product standards relate both to manufacturing methods and costs and to marketing considerations. When such is the case, standards are generally determined by the combined judgment of factory and marketing management.

STANDARDIZATION—TYPES, METHODS, AND CONTROL

History of Standardization. As early as 2000 B.C., attempts were made to standardize money. Because of money's peculiar nature and use, it was recognized that certain standards of purity are essential for such a medium of exchange. Although the Guilds of the Middle Ages did much to establish standards of craftsmanship, little real progress was made until after the Industrial Revolution when ability to control the output of machines made it feasible to establish standards to which products could be conformed and which could be maintained. Widened markets made sale by description essential. That the distant buyer might be fully protected, our federal government early began to authorize certain standards and to help in spreading and enforcing them. Constant increase in the number, refinement, and serviceability of grades has characterized government activity in that area.

Types of Physical Standards. Standardization implies the development and adoption of certain classifications. It involves the application of certain measurements or other common qualities to the commodities to be standardized. To be of value, standards must be based on qualities or characteristics that affect the usefulness of products. The major types of standards that relate to the physical properties of goods may be classified as having to do with: (1) basic weights and measures; (2) sizes, shapes, or dimensions; (3) chemical or technical properties; (4) product performance; (5) quantity units for sale or handling; and (6) characteristics apparent to human senses.

Basic Weights and Measures. Numerical standards of measurement are basic to trade. Ordinary measures such as the foot, the ton, the dozen, the gross, and the pound are illustrative. Somewhat less commonplace but also significant numerical measures include kilowatts for measuring electric power and units of horsepower for rating motors.

Sizes, Shapes or Dimensions. Size or dimension is a common basis of standards. Sometimes the unit is very precise, as in the case of certain standard sizes which have been set up in the lumber industry. Yet the inch board varies considerably in actual thickness. Fruit is supposed to be graded in part by size, yet a dozen apples or oranges of the same supposed size vary greatly in actual size, measurement, or weight. For this reason, the tendency is to sell fruits and vegetables by the pound instead of the dozen. Hats, shoes, and clothing are illustrative of the common use of size as a basis of standardization in the marketing of manufactured products.

Standard sizes for wearing apparel afford a significant opportunity for further standardization. A woman purchasing various types of wardrobe items is usually concerned with a number of different and confusing dimensions of size. For example, one who purchases a size 12 dress may purchase a size 34-B brassiere, a size 26 girdle, a size 34 slip, a size 36 sweater, and a size 10 coat. Studies made by the U. S. Department of Commerce, published in 1954, have suggested the possibility of classifying all women according to nine body types, consisting of three bust-hip groups for each of three height groups—tall, regular, and short. If such recommendations are eventually accepted by industry, it would be possible for a tall girl of a certain type and group wearing a size 12 dress to ask for a size 12-T (T for tall); also to buy a size 12-T brassiere, girdle, slip, sweater, and coat.

Chemical or Technical Properties. Scientific standards are among the most useful and accurate types, even though they may be hard to determine and even more difficult to enforce. Thousands of commercial articles are manufactured in accordance with definite chemical formulas and hence are carefully standardized. Chemical analysis may be used to test the conformity

of such products to the established standards. The Federal Pure Food and Drug Act is based on the assumption of the wide use of scientific standards. The Bureau of Standards has aided greatly in the development of scientific methods and in making its findings available for the use of industry.

Product Performance Standards. Product performance standards are of very great significance, especially in industrial marketing. In this classification are included such attributes as speed, power, operating temperatures, durability, or operating cost characteristics. Some such standards are developed by manufacturers and are publicized by them in connection with the promotion of their products. In other cases, the standards are specified by purchasers and written into purchase agreements.

Quantity Units. Various types of quantity standards are applied to package sizes or units of sale. Illustrative are butter by the pound, industrial paint in 50-gallon drums, fertilizer in 100-lb. bags, and paper by the ream. The sale of consumer goods, especially in the food category, is often criticized because of a lack of adequate standardization. In the typical supermarket, a wide variety of can sizes for fruits and vegetables or many different weights of loaves of bread are to be found. Differences are often slight, but they make price comparisons difficult. Great strides have been made, nevertheless, in adopting standard units of sale by *prepackaging* many items formerly sold in bulk. In the food store of the 1920's, it was common for grocers to handle fresh fruits and vegetables, crackers and cookies, dried fruits, sugar, and many other items in loose containers, weighing out amounts at the time of sale as requested by customers. Prepackaging of such items has added to costs on the manufacturing or processing level, but have greatly reduced costs in retail establishments and at the same time have brought about a reduction in waste, improvements in sanitation, closer identification of product and brand name, and more consumer confidence in the quality and value of products thus purchased.

Characteristics Apparent to Human Senses. Many quality factors are not precisely measurable but are still significant for purposes of standardization and grading. Examples include color, appearance, flavor, odor, or taste. While such characteristics are hard to define and must often be appraised by human reaction, they are very important in classifying commodities such as wine, cheese, canned fruits, meat products, and baby foods. This is further illustrated by the use of an automatic color-sorting machine which electronically, by means of a phototube, sorts lemons into several color classes of ripeness and quality.

Multiple Types of Standards. Many types of commodities are graded on the basis of standards which combine two or more of the above-mentioned bases. Lumber is standardized as to size but is in addition graded on a

quality basis. A common grade of boxed apples is "Fancy Delicious, 128's" which means that a box contains exactly 128 Delicious apples of the middle grade of quality, the other two grades being "Extra Fancy" and "C grade." Peaches, lettuce, celery, and other commodities are graded on the basis of both size and quality. Hogs are divided first by weight into grades, and then each of these grades is subdivided on the basis of quality. Thus common grades used in most of the central stockyards are "light weight, common, medium, good, and choice." Cotton is long staple or short staple and is further divided into a large number of grades which denote quality.

Methods of Accomplishing Standardization. Methods of securing conformity with established standards vary with different products. It is comparatively easy to manufacture in such a way as to conform to predetermined standards. Chemical combinations can be made to agree with established formulas. Foundry products can be shaped in accordance with established designs and molds. Other products similarly conform. There is usually a percentage of articles which must be rejected entirely or sold as "seconds" because they are not of standard quality, but such articles can normally be detected by careful inspection.

Standardization is not so easily accomplished in the extractive industries. Farm products take form in accordance with natural laws and not in obedience to man's desires. Lumber is good or poor, depending upon growing conditions over the past years; and the quality of livestock is partly determined by the presence or absence of diseases and by the quality of the food supply, as well as by conditions which are under the grower's control such as the amount of food supplied and the sanitation practiced. The result is that products of the farm, range, forest, and mine vary greatly in quality. A given lot of such commodities will in all probability contain material of several distinct grades. Even though careful standards have been established and are in general use, there remains the problem of grading the miscellaneous groups to conform with the standards. This may be done by one of several methods.

A common method of grading is by use of judgment, known as the "eye value method." Experienced livestock buyers can determine with a rather high degree of accuracy the weight of a pen of cattle or hogs and the quality of meat which they will produce. Lumber is sorted in accordance with the judgment of experienced men. Tobacco and cotton are purchased in local markets on the basis of classifications made by the judgment of buyers. Wool and cotton are graded in central markets by the judgment of graders who are sometimes assisted by standard samples of each official grade. In case of doubt the fibers inspected can be compared with the official standards. In fact, grading by judgment is perhaps the most common

and the most important method of dividing commodities into their proper classifications.

Scientific tests are used for grading some commodities. The Babcock test is important in determining the butter-fat content of milk and cream. The scientific development of dairying in this country since the 1920's has been largely due to the emphasis on the varying qualities of milk as shown by results of the test. Coal is tested to determine its heat content on the B.T.U. (British thermal units) basis. Chemical tests are used to determine the cotton and wool content of textiles.

Machines of different kinds are used for grading certain commodities. In some cases the principle applied is that of passing the units to be graded over a series of holes of different sizes and thus separating them into size groups by this rather crude method. Apples and oranges are sized by a similar device which also sorts the fruit according to its weight. Potatoes and onions are similarly graded.

The Control of Standards. Standards must be subjected, of course, to some form of control. It is of little value to adopt them unless there is some assurance that they will be observed. Federal and state governments have taken the responsibility of developing and enforcing standards in certain lines; in others, private organizations such as trade associations assumed most of the burden.

One of the outstanding government agencies is the Federal Trade Commission, which has developed many standards as part of its work in preventing unfair competition. A number of industries have cooperated with the Commission in formulating "Trade Practice Rules" which often give attention to standards to be used in labeling or describing products. Illustrative are regulations regarding the use of the words "veneer" or "walnut" on furniture, "rayon" as a substitute for silk, and rules established for describing fiber content of textile products. Once such standards have been agreed upon by a majority of the members of an industry and incorporated in the Trade Practice Rules adopted for the industry, a violation may be regarded as an unfair trade practice.

Another very important government agency is the Commodity Standards Division of the U. S. Department of Commerce. This agency assists industry groups in developing their own standards when this is deemed to be in the public interest. Tentative standards are publicized to producing, distributing, and consuming interests for written acceptance. If no valid and active opposition is recorded, such standards are promulgated as voluntary standards of the trade. Each commercial standard so developed contains the recommended wording of a statement that may be printed on a label indicating compliance with its requirements, as follows:

> These ________ comply with Commercial Standard CS ________, as developed by the trade, under the procedure of the Commodity Standards Division and issued by the U. S. Department of Commerce.

Hundreds of such standards have been developed for such diverse products as artists' oil paints, body measurements for the sizing of infants' apparel, cast aluminum cooking utensils, surgeons' latex gloves, lead pipe, fuel oils, sunglass lenses, wall paper, and red cedar wood shingles.

The Food and Drug Administration which administers the Food, Drug, and Cosmetic Act of 1938 has done much to develop and enforce standards for the classes of commodities under its jurisdiction. A food is considered misbranded if it is represented as, or purports to be, a food for which a standard has been prescribed, unless it conforms to that standard. To protect consumer interests in cases where no standards have been developed, the Administration has the power to establish standards. This power is given in a section of the Act which states that:

> Whenever in the judgment of the Administrator such action will promote honesty and fair dealing in the interest of consumers, he shall promulgate regulations fixing and establishing for any food, under its common or usual name so far as practicable, a reasonable definition and standard of identity, a reasonable standard of quality, and/or reasonable standards of fill of container.

Similar authority is given in other sections of the law that pertain to drugs and cosmetics.

The Agricultural Marketing Service of the U. S. Department of Agriculture is the agency primarily responsible for the development and use of standards in connection with the marketing of farm commodities. This bureau cooperates with business and agricultural interests and has developed standards of quality for more than 100 commodities. Use of these standards is, for the most part, permissive but is constantly increasing, and use of certain of the standards is mandatory under specified conditions.[1] In any event, such standards are widely used in wholesale transactions of all kinds, are indispensable to speculative or hedging contracts for future delivery, and some of them are also carried through to the retail level of distribution, as illustrated by the standards developed for meat, eggs, and potatoes. The Department of Agriculture also has authority under several federal laws to develop and enforce the use of standard measures or units of sale in the interstate commerce of farm commodities. An important result of much diligent work along this line has been a substantial reduction in the number and variety of sizes and shapes of such containers as berry boxes, grape baskets, and many others.

[1] Official Department of Agriculture Standards must be used in all interstate transactions involving grain and cotton. Also, the federal grades of all commodities stored under the U. S. Warehouse Act must be shown on warehouse receipts.

The various federal laws and regulations with reference to interstate commerce have been supplemented by state laws affecting intrastate commerce, especially in farm products. Unfortunately, standards and grades specified in the latter do not always follow the federal specifications or those of other states. Such conflicting standards cannot be viewed as other than a confusing impediment to the free flow of goods in interstate commerce. This is particularly true under the laws of some states which require that all of certain specified commodities sold in the state *must* be graded according to the state grades. It has often been charged that some state laws have been established to protect home-grown products from competition with the same products grown in adjoining states, a legislative policy of very questionable public value.

The discussion in the preceding paragraphs has indicated some of the most significant areas of government control over standards. Also of substantial importance is the control exercised by the business community through trade associations, professional organizations, and the activities of individual companies. One of the most important agencies in this regard is the American Standards Association, a federation of some 2,000 companies and numerous industry or trade associations. This organization operates as a standards clearing house for business and consumer groups. When the need for a standard is recognized by an industry member, a proposal is made to an appropriate technical committee and a trial standard is developed. This is submitted to industry and consumer groups for approval and, if accepted, is then approved as an official "American Standard" which may be used by any manufacturer who wishes to adopt it. Professional organizations such as the Society of Automotive Engineers and the American Institute of Electrical Engineers have done much by establishing standards for mechanical products and by aiding in enforcement through their influence on buyers. Testing laboratories, now common in both industrial plants and large retail stores, are of considerable aid in encouraging the manufacture of goods which conform to predetermined standards. Illustrative are the laboratories operated by Sears, Roebuck and Company, the R. H. Macy & Co., the Kroger Company, and a testing laboratory operated by the National Retail Dry Goods Association for the benefit of its members.

Services of Standardization

Standardization has been classified as a *facilitating* function. The benefits derived from standardization can be appraised by an analysis of the manner in which it facilitates the performance of each of the other marketing functions.

Standardization and the Functions of Exchange. Standardization affects buying and selling in a similar manner, since there are two parties to every exchange of goods.

Bases of Sale. Increasing degrees of standardization have made possible more economical methods of exchange. *Sale by inspection* was at one time the prevailing basis of sale. Goods were purchased in bulk on an "as is" basis, and the buyer had no recourse if he was dissatisfied after the purchase. Even at present, as in many auctions, this method is used widely. Style goods are sold to consumers only after careful inspection and comparison. Some coal is purchased as "mine run," and many sales of fruits and vegetables take place only after the exact condition of the offering has been determined by careful inspection. Obviously sale by inspection is cumbersome and inaccurate and, because it is essentially uneconomic, gives way to sale on the other two bases, *description* or from a *sample*, as often as possible. Yet there is no reason to believe that sale by inspection can be entirely eliminated by standardization. Some products are so highly perishable that their condition cannot be described accurately, nor can a fair sample be submitted. Buyers often decline to purchase other than by inspection from shippers whose reputation is not established or is definitely bad.

Sale by sample is midway between sale by inspection and sale by description. It involves a physical inspection of a sample supposed to be representative of the entire lot offered for sale. It assumes that the sample was taken at random and that the goods run true to sample. Moreover, the prospective purchaser must have confidence that the seller can and will deliver goods like the sample. Many raw materials such as grain, sugar beets, iron ore, and milk are sold on this basis. Retailers sell many goods, like furniture, from floor samples but make deliveries from warehouse stocks.

Sale by description is more scientific than either of the other two bases. It is economical and facilitates speedy exchanges. Description may be conveyed by word of mouth, by blueprints, by printed or written words, by spoken words on the radio or telephone, or by symbols printed in catalogs or transmitted by wire or letter. Often the specifications, i.e., the descriptions, are laid down by the purchaser who thus indicates exactly the kind of goods he desires. Relatively few words often serve to give a clear picture of goods exchanged on the basis of description. "No. 2 Northern" and "High Middling" have such a definite meaning in the minds of dealers in wheat and cotton, respectively, that they are willing to stake their fortunes on price fluctuations without troubling themselves over the question of identifying the grades in transactions involving thousands of bushels or bales. When consumers call for articles by brand names, they buy by description—a hint of the prevalence of this important basis of sale. Ob-

viously, sale by description is limited to goods which can be described in such a manner as to indicate just what quality, color, or flavor is involved.

Other Aids to Exchange. Careful grading in accordance with established standards is of further benefit in that it often allows a seller to receive a premium for products so graded. For example, the demand in any market is not for just any kind of oranges but for oranges which conform to certain size and juice content standards. Those who know what these demands are and produce the quality of fruit which is demanded receive a reward for their skill in analyzing the market. An allied gain is the possibility of selling grades lower than the best in markets where consumers prefer or must use them because of low income. Chain grocery stores apply this principle when they grade quarters of beef and send those not of the highest quality to sections of their market which are composed of persons with relatively low income and hence welcome an opportunity to secure the lower-priced cuts.

Futures trading and hedging, two market practices indispensable to modern business, could not exist were it not for the careful grading of commodities. Futures contracts are based upon the ability to deliver commodities of standard or contract grade or to pay or receive a differential based upon established differences in quality. Likewise, sales in transit, so common in the fruit and vegetable industry, are made feasible only by the use of established grades. The sale of branded merchandise by means of advertising is effective only because of highly standardized production processes which make it possible continuously to supply products of identical quality to large numbers of buyers.

Standardization and the Functions of Physical Supply. The establishment of standards and the practice of grading in accordance with accepted standards have made possible a number of economies in transportation. Before the days of the Babcock test it was necessary to keep each farmer's milk or cream separate while it was being hauled to the market or to buy it on a weight basis only and to disregard the differences in butter-fat content. Now shipment can be made in large containers filled with the products of a number of dairymen. Grading of hogs and grain make it possible to ship the product of a number of farmers in a single car. Fruit is graded at the orchard or packing house and is combined for shipment. A second saving is that careful grading eliminates culls or products so poor as not to justify shipment to markets. They can be destroyed, sold in the local market, or shipped to a nearer place of sale and not be forced to absorb the costs of shipment. Thus the cost of transportation, expressed as a percentage of the higher price usually received for graded products, is much less.

Standardization effects similar economies in storage, for commodities properly graded need not be kept separate while in storage. This results

in substantial economies in the utilization of storage space and makes the cost of storage much less than would otherwise be possible. The modern grain elevator system is based upon this principle. Obviously if the poorer grades are eliminated by the grading process, only those which justify storage will be stored. It is also true that the elimination of poorer or damaged grades reduces some types of damage while in storage. Here, too, the cost of storage represents a smaller percentage of the price received for the graded product.

Effect of Standardization on Other Facilitating Functions. Standardization aids in reducing the risk element in distribution. Futures trading depends on standardization. Market information is valuable only when it applies to known qualities of a product. It is comparatively useless, for example, to know that tobacco is quoted at a certain price unless the grade of the tobacco is known. Standardization widens markets through its aid to demand creation and thus reduces the risk which follows confinement of sales to a narrow market area.

Standardization aids in financing, especially in connection with goods in storage. Because of the reduction of risk which follows careful grading, it is possible for distributors to borrow a larger amount on collateral used as the basis of a loan than would otherwise be possible. Warehouse certificates are useful as security for loans only when they represent a commodity the value of which has been established by testing its conformity to established grades. Changes in price can be followed with intelligence through a study of market reports. Since there is a ready market for most graded commodities, the collateral can be disposed of quickly when conditions warrant such action.

Simplification and Standardization

Closely related to product standardization, but distinctly different in meaning and objective, is the practice of product-line simplification. While standardization is concerned with the determination of basic measures or limits and the process of conforming to such standards, simplification involves the elimination of superfluous variety. Standardization can thus exist without simplification, for there can be thousands of the same type of item, each with its own standard of quality or dimension. Standards are, however, a prerequisite to simplification, since in the absence of standards there can be no clear conception or understanding as to the items or types to be eliminated from the line of products of an industry or a particular firm.

Simplification by Individual Firms. Application of scientific principles to the management of manufacturing companies emphasized one very common condition, namely, the production of an unnecessary diversity of

products. Accordingly, many manufacturing and sales departments began to work together to discover just how many varieties of each product were necessary. It was often discovered that many could be eliminated with corresponding savings. One hat manufacturer, after discovering that 90 per cent of his sales were being made in seven styles and ten colors, stopped production of several hundred other combinations.

Similarly, many kinds of wholesale and retail middlemen have practiced some degree of product-line simplification with great resulting economies in selling and in physical distribution. Within a particular class, the variety of products available to a merchandising organization is almost limitless. In a chain supermarket organization, for example, hundreds of different brands of canned green beans may be available to the buyer. The vast majority of consumer wants may be satisfied, however, if the product-line offering is limited to three or four brands that represent significant quality and price differentials. Similarly, in the men's shoe trade there are more than 200 different sizes, counting length and width combinations, but about 85 per cent of total sales is accounted for by only 45 such sizes. Consequently, many popular price shoe stores simplify their product lines by concentrating only on the best selling sizes for which there is a ready demand.

Industry-Wide Simplification. Just as standards are often established on an industry-wide basis, so too have many industries cooperated in developing simplification programs through the support of the Commodity Standards Division of the U. S. Department of Commerce. When approached with a request for assistance, this Division works closely with the trade association for the industry in surveying normal demand for each of the items currently being produced. Recommendations for the elimination of unnecessary items as, for example, certain sizes of the product, are then drawn up and publicized to all interested manufacturers and distributors and to consumer groups. If approval of the recommendations is secured from 80 per cent of the interested parties, they are promulgated as Department of Commerce "Simplified Practice Recommendations." Compliance is strictly voluntary but is usually widespread because of the general benefits of such a practice. Hundreds of simplified practice recommendations have been developed through such voluntary cooperation and they are reviewed periodically to insure that they are currently in line with the requirements of industry and trade. Illustrative of the significance of industry-wide simplification is the reduction in the variety of pipe fittings. Prior to the development of simplified practice, over 17,000 different standardized fittings were manufactured by the industry. Most of these were found to be nonessential and the industry now concentrates on the production of several hundred fittings which are deemed adequate for the needs of all affected groups.

Advantages of Simplification. The practice of simplification by individual companies and by cooperating groups within industries has developed with some rapidity because of certain inherent advantages. Manufacturers have found it worth while because it reduces the amount of capital which must be invested in raw materials and semi-finished stock and especially in such items as patterns and repair parts. Reduction in the number of models is conducive to larger-scale manufacturing. Employees are more efficient because they can be more highly specialized in their duties. Goods can be delivered more promptly to retailers or consumers because the number of models which must be carried in stock is less; and there is, therefore, considerably less danger of being out of commodities ordered. In fact, the entire rate of turnover of capital and merchandise is increased with simplification.

Wholesalers and retailers gain similarly. There is much less chance of having out-of-date or obsolete stock if the number of styles or models is reduced. Stocks become more staple and are more easily purchased, with less chance of buyers going wrong in their selections. Inventories can be reduced when stock is simplified. Distributors have found that these and other economies result in the ability to quote lower prices to buyers with consequent increased sales. The consumer gains through lower prices, quicker and more certain deliveries, and better service on repair parts.

Limitations to Standardization and Simplification. Even though standardization and simplification have been distinguished in meaning, certain common limitations apply equally to both. Perhaps the major limitation is public interest in style and fashion. Style movements are essentially opposed to standardization, for new commodities, new dimensions or forms of old commodities, or new combinations are all the basis for style and fashion. The desire for individuality is so pervasive that it severely limits standardization and simplification even in many large-scale, mass production industries. For example, even in a large parking lot, it is difficult to find two automobiles which are precisely identical. Consumer preferences for color, body style, type of upholstery, and optional equipment result in an endless variety, even within a given make of car for a given model year. In the case of ready-to-wear apparel, this is even more important, especially in the higher price ranges. Many hats and high fashion dresses will be purchased by the consumer only if she believes that no identical item will be sold in the same community.

Many small firms have found that their principal competitive strength lies in their ability to offer products or services which are not so highly standardized or simplified as those offered by competitors. The ability to render particularized service is an inherent strength of the small firm in both manufacturing and retailing.

It is apparent that both standardization and simplification have definite advantages. It is equally apparent that certain limitations are in operation. Every producer is faced with the necessity of deciding how far he should go in the adoption of standards and standardized processes. There is little question that society has benefited from the adoption of certain standards, but the process can be carried too far.

Standardization and the Consumer

There is little doubt that most aspects of standardization and simplification have been accomplished primarily from the point of view of manufacturers and middlemen. Many students of marketing and representatives of organized consumer groups have pressed for more adequate consumer buying standards and for more information to be placed on labels attached to the goods. It is believed by many that some labels are misleading in that they do not give the type of information which the consumer needs, while others are sometimes definitely or positively misleading.

Need for Information. Few would deny that the consumer is entitled to know what he is purchasing. Yet it is not always easy for him to gain such knowledge. The great variety of labels and brands which characterizes modern distribution makes the consumer's problem even more complex. The problem is, obviously, in part one of knowing what the product is and then of knowing whether the quality or its basic components are such as to yield maximum value. Consumers are, therefore, forced to rely upon what is often inadequate information. Advice of salespeople is of varying completeness and reliability. Brands are helpful in making repeat purchases of goods which have proved to be satisfactory or of avoiding those that were unsatisfactory, but they are of limited usefulness when the initial purchase is made. If the brand is that of a reliable manufacturer, or if it is the private brand of a distributor in whom the purchaser has confidence, purchases may be made with fair assurance of securing good quality. Often other brands may identify goods of inherently better quality or of a quality which will give greater economic value for a particular user or purpose.

Manufacturers who desire to aid consumers by supplying the kind of information which will enable the buyer to standardize his purchases are confronted by an important difficulty which grows out of the fact that three types of labels are now in use. Some consumers, producers, and middlemen seem to prefer one, and some, another. The three types are *grade* labels, *descriptive* labels, and *informative* labels. Although each is distinct, there is some overlapping in their use in actual practice.

Grade Labels. Grade labels imply quality specifications designated by a number, letter, or other symbol. Illustrative are the four grades established

by the Agricultural Marketing Service of the U. S. Department of Agriculture for fruits packed in tin. They are A Grade or Fancy, B Grade or Extra Standard, C Grade or Standard, and Off Grade or Substandard. Each grade is determined by the degree to which the product meets certain value factors rated by the Bureau as follows: tenderness, 40; flavor, 20; absence of defects, 15; uniformity of color and size, 15; and clearness of liquid, 10. If the product rates below 60, it is Substandard. If it is from 60 to 74, it is C Grade. If it rates from 75 to 89, it is given the rating of B or Extra Standard; and if it falls between 90 and 100, it is classified as A Grade or Fancy. Eight grades for beef and four for eggs are federally authorized.

Advocates of grade labeling have advanced several reasons for their position. The system is said to be simple and definite, as it involves only the selection and weighing of the essential qualities of a product and the use of a letter or similar symbol to designate its relative quality standing. It is assumed that when this is done, the consumer will be able, for example, to purchase Grade A peaches for one purpose and Grade B for another and that a given grade will always indicate the same, uniform quality characteristics. It is further claimed that wide use of this type of labeling would make for price differentials that are adjusted to actual and intrinsic values of products of different grades rather than to artificial and fanciful considerations.

The controversy that has been raging on the subject for some years is at once indicative of differences both in interests and in honest opinions concerning the results which wide use of grade labeling is likely to produce. Some students of the problem seriously doubt the ability of any small group of persons like government officials, even with the cooperation of members of the trade, to select and weight the essential qualities of a product, or to discover just which of these qualities are present in a given product and in what degree. Where style is of significance, the wisdom of such a questioning attitude is quite apparent. Even in the matter of such relatively simple products as canned fruits and vegetables, there is the question of flavor. *Is* flavor important? *How* important is it? *Who* is to judge what is good flavor for any one person or for a group of persons? *Can a grade symbol embody or measure such a characteristic?*

There seem to be other objections to grade labeling as a substitute for all other kinds of labeling. One is that a grade symbol does not provide enough opportunity for adequate information as to the real variations in quality. If, for example, one can of asparagus is rated 88 or 89 and is placed in Grade B and another is rated 90 or 91 points and is placed in Grade A, the purchaser of the Grade A can pays more than he should and would be better off had he bought the Grade B that is of nearly equal quality. This suggests the possibility of some vendors following a policy of just meeting

the minimum standards for a given grade and the quality of whose products would thus be quite inferior to that of the same grade designation made by another manufacturer. It is suggested that the manufacturer of the better quality in a given grade still has the opportunity of convincing the trade and consumers of that fact through effective advertising and through branding. On the other hand, it is pointed out, the degree of reliance by consumers upon the grade borne by the label to that extent nullifies the value and effectiveness of the manufacturer's brand and advertising. This belief no doubt explains the opposition to grade labeling on the part of producers who have succeeded in creating a demand for their brands and also on the part of advertising men and media generally.

Grade Labeling in Practice. Since 1941, the Agricultural Marketing Service of the U. S. Department of Agriculture has made available on a voluntary basis a continuous inspection and grade-labeling service. According to the regulations in force, any member of the food canning industry may participate in this program. In order to do so, the company must continuously meet certain requirements with respect to sanitation, lighting, screening, pest control, purity of water supply, and refuse disposal. If this is done, the canner has the right to include on his labels the following statement: "Packed under the continuous inspection of the U. S. Department of Agriculture." This is to be accompanied by a statement indicating whether the product is of Grade A, B, or C, as was explained above. The number of concerns participating in this program has increased steadily, but they consist primarily of small companies that account for a small proportion of the output of the food canning industry. Most canning companies, and particularly the larger ones, believe that they have nothing to gain from the use of grade labels and that more may be gained with the time and money expended in publicizing the standards of quality implied by their own brand names.

The very recitation of the advantages of grade labeling and the objections thereto, as stated in the foregoing discussion, constitutes a statement of the complicated nature of the problem and the diversity of viewpoints, some of which are grounded in selfish motives and others are purely objective. It is, therefore, extremely doubtful whether any one type of labeling will for some time replace all others for any given class of products or for goods in general.

Descriptive Labels. This type of labeling implies that the labels carry terms descriptive of each of the significant characteristics of the product which are susceptible to objective measurement. Thus such items as size, variety, sugar content, seasoning, texture, packing method, and workmanship would be listed on the can of fruit or vegetables. Illustrative are such statements as there are "approximately eight to ten figs packed in heavy syrup." Others give the number of slices of pineapple or the number of

halves of peaches in a can. Pictures showing the exact size of peas known as "sifted" or "early June" are a part of the same movement.

An order of the Federal Trade Commission which established definite rules for distinguishing between silk and rayon garments is a case in point. The order requires both manufacturers and retailers to indicate that a dress is "wool rayon" rather than "silk and wool" and that it is not sufficient to label a fabric as "taffeta" when it is really made from rayon. It further requires that the particular variety of rayon be indicated. Under the Wool Products Labeling Act of 1939 the Federal Trade Commission requires that wool products be so branded or labeled as to indicate the kind of wool fiber—virgin, reprocessed, reused, etc.,—and the percentage of such wool by weight of the total product.

Several further illustrations of descriptive labeling may be cited. Manufacturers of vitamin products often supply on labels such information as the following: "One teaspoonful (5 cc.) contains 3,000 USP units of Vitamin A, 800 USP units of Vitamin D," etc. Some manufacturers of sheets and bedding include information indicating the weight in ounces per square yard, the number of threads per inch of material, and the number of stitches per inch in seams and bindings.

Informative Labels. Although both descriptive and grade labeling are informative, certain items of information of value to consumers are not included in either of these types of labels. Informative labeling therefore supplements or in some cases replaces descriptive and grade labeling by providing information that goes beyond the characteristics of the product that can be stated in terms of objective measurements or by designated symbols. Manufacturers of medicinal preparations have for years used this type of labeling in providing instructions concerning recommended dosages and possible harmful effects if the product is not used according to directions. Food canners often supplement descriptive labeling with information about maturity of the product, its color, and suggestions as to preparation or alternative uses. Many items of wearing apparel now are sold with labels that state whether the product is washable or should be dry cleaned and, if washable, the method to be used. Unfortunately the information presented on some labels is of little value to buyers as, for example, the label which has been used on a certain blanket stating, "The heat transmission of this fabric has averaged .100 Cal./degree C./sec./1000 sq. cm." Even the further statement that this rating indicates "high" warmth means but little to the nontechnical buyer.

Combination Labeling. The movement for more exact and helpful labels is a movement for a definite form of standardization and one which should mean much to consumers in the future. The trend toward providing more valuable information has been *accelerated by the more widespread applica-*

tion of self-service methods in retail distribution. This has led many manufacturers to adopt some combination of the various types of labeling discussed above. Canning companies that have adopted the voluntary grade labeling program of the Department of Agriculture often provide additional description and information beyond that conveyed by the designated grade symbol. Those who have not used grades in labeling very frequently convey needed purchasing information through a combination of descriptive labeling giving factual data about the product that is susceptible of objective measurement and informative labeling about the use, preparation, durability, or care of the product. Although much has been accomplished along this line, examples are legion of products where the producer, distributor, and retailer would all benefit from the provision of additional or more meaningful information that would help consumers to purchase intelligently.

Consumer Testing and Rating Agencies. Recognition of the consumer's difficulty in judging the relative merits of competing products has resulted in the formation of consumer testing and rating agencies which evaluate different products and publish recommendations in monthly magazines made available to consumers on a subscription basis.

The oldest such organization is Consumers' Research, Inc., which was founded in 1929 for the purpose of testing, studying, and reporting "on goods and services from the point of view of their selection, purchase, and use by the ultimate consumer." A second agency, Consumers Union, was founded as an offshoot of Consumers' Research in 1936, "in response to a widespread demand for a competent, honest and unbiased technical service for consumers, which would be controlled by its members and responsive to their needs." These are the only consumer-financed agencies that publish ratings on a wide variety of products. Consumers' Research, Inc., publishes its findings in *Consumers' Research Bulletin*, which is said to have a circulation of about 100,000, and Consumers Union publishes its in *Consumer Reports*, with an alleged circulation of about 715,000.[2] Both of these publications contain frequent articles on different kinds of commodities. Technical information on product developments is discussed from the consumer point of view, and numerous individual products are rated in *Consumers' Research Bulletin* as "Recommended," "Intermediate," or "Not Recommended," and in *Consumer Reports* as "Best Buys," "Acceptable," or "Not Acceptable." Both organizations claim that a majority of their recommendations are based on tests conducted by their own staff in their own technical laboratories, in which a variety of scientists, engineers, and technicians are employed. Some ratings are based on data published by the National Bureau of Standards, the American Medical Association, and tests made by private agencies.

[2] Eugene R. Beem and John S. Ewing, "Business Appraises Consumer Testing Agencies," *Harvard Business Review*, March-April, 1954, p. 114.

While the purposes of these agencies are laudable and have been in part fulfilled, their weaknesses must not be overlooked. One of the most important of these is to be found in the limited funds and facilities for testing work. As a result, the ratings given are often based on inadequate information. Many types of tests are destructive of the goods tested, which makes the testing of a representative sample of durable goods items prohibitively expensive. Tests are usually made under artificial rather than actual use conditions. Undue weight may be given to relatively minor factors. It is not always known what factors have been taken into account in determining the quality and value of the product. The testing difficulty is illustrated by the circumstance that has sometimes prevailed whereby the two leading agencies have given ratings for the same product which are directly contradictory of each other. Second, many products cannot be appraised satisfactorily on the basis of measurable standards. The matter of style plays an important role in the sale of much merchandise. Also, the reputation of a manufacturer with regard to guaranty policy and service facilities is a matter of great importance to consumers in purchasing numerous products.

The circulation of both of the major publications described above is much higher than in the years prior to the 1940's, which doubtless reflects increased consumer interest in objective buying information, even in prosperous years. Nevertheless, both publications were being used only by about 5 per cent of American families in the mid-1950's. It is apparent, therefore, that their influence in guiding consumer buying is not great, and it is not expected that it will soon, if ever, become so.

On the other hand, their influence on the business community has perhaps been more substantial. One research study has indicated that most business firms are very sensitive about the ratings that their products receive in these consumer publications.[3] When companies receive unfavorable or low ratings, product standards are often evaluated, and many specific standards have been modified in attempts to receive higher ratings. Some middlemen have changed sources of supply, especially for private branded products, when the items that they sell consistently received bad ratings. In some cases, business firms have attempted to capitalize upon favorable ratings by using them for sales promotion purposes. While neither Consumers Union nor Consumers' Research, Inc., permit this to be done with their cooperation, photostats of their favorable ratings have appeared in individual company sales literature and advertising, sometimes with a significant response from the consuming public.

In spite of the limitations of consumer testing and rating agencies, and despite the limited circulation of their publications, it is believed that they are performing a valuable social service by providing interested consumers with some objective or disinterested buying information and at the same

[3] *Ibid.*, pp. 116–20.

time furnishing an incentive to quality improvement and the raising of product standards through their influence upon the business community.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   a) standardization
   b) general standard
   c) private standard
   d) Commercial Standard
   e) simplification
   f) Simplified Practice Recommendation agencies
   g) grading
   h) grade labels
   i) descriptive labels
   j) informative labels
   k) consumer testing and rating
2. What does each of the following agencies or organizations have to do with standardization or simplification?
   a) Federal Trade Commission
   b) Commercial Standards Division of the U. S. Department of Commerce
   c) U. S. Food and Drug Administration
   d) Agricultural Marketing Service of the U. S. Department of Agriculture
   e) American Standards Association
   f) Consumers' Research, Inc.
   g) Consumers Union
3. Explain why the subject of "prepackaging" is of interest in connection with standardization.
4. How does the process of accomplishing standardization differ between manufactured products and agricultural products or products of the extractive industries?
5. In a manufacturing corporation, who should be responsible for standardization—the official in charge of manufacturing or the official in charge of marketing? Explain your position.
6. "The task of marketing is to distribute the goods which have been manufactured." Criticize this statement. Is there any connection between your criticism and the concept of standardization as a marketing function? Explain.
7. Is there any relationship between self-service merchandising and labeling? If so, point out how the two are related.
8. Why, in the face of very apparent advantages to be secured by standardization and simplification, do some producers fail to adopt such processes?
9. What would likely be the effect of compulsory grade labeling upon:
   a) Competition?
   b) Advertising?
   c) Buying habits of consumers?
   d) Manufacturers of high quality products?
10. Does the consumer have anything to lose through grade labeling?
11. How far should the government go in the establishment and control of standards?

12. If you were responsible for controlling prices during an inflationary period and you wished to do so by establishing price ceilings, would there be any justification for your desiring grade labeling? Explain. If you did require grade labeling, what problems would you encounter?

13. In order to justify the classification of standardization as a facilitating marketing function, show how this function facilitates the performance of each of the other seven marketing functions.

14. A leading manufacturer of men's neckties has an established brand name and a good customer following among men's clothing and furnishings stores that handle merchandise in the higher price ranges. In order to diversify the merchandise offering, the company has decided to manufacture high quality, style-appeal men's shirts. Preliminary market studies have revealed that broadcloth, oxford, madras, and gabardine are popular materials for regular and sport shirts. Sizes range from 12 to 20 for collars and from 30 to 38 for sleeve lengths. Plant facilities are such that production will be limited to about 200 shirts a day. What decisions must be made insofar as standardization and simplification are concerned?

15. In order to take advantage of a lower capital investment and a more rapid stock turn, the Jones Shoe Store reduced the variety of its styles. The resultant loss of patrons worried the proprietor considerably. In an attempt to bring back the trade, he added lines from time to time. Soon he was back to his first predicament and the inefficiencies of high inventories continued unchecked. What course should the proprietor have taken in order to keep his inventories down without losing customers?

25

MARKET FINANCE: BUSINESS

In order to create values through the performance of marketing activities, various costs must be incurred and all of them must be financed. The functions of exchange and physical supply, as well as other facilitating functions, are possible only through adequate financing with suitable types or kinds of capital or credit facilities. In this chapter are considered the nature and problems of the types of financing that are necessary for the successful performance of marketing functions in the channels of trade. The type of credit that is used by ultimate consumers to facilitate the process of consumption is an area of financing with a distinct character, purpose, administrative requirements, and problems and is, accordingly, given special consideration in the following chapter.

Capital Needs in Marketing

To carry on the necessary marketing activities, an enterprise needs at least two major types of funds, one for permanent investment and the other for temporary or short-term financial requirements.

Permanent Capital. Permanent or long-term capital must be supplied for the purchase and acquisition of fixed assets such as land, buildings, delivery equipment, furniture and fixtures, warehousing equipment, and other assets of a more or less permanent nature. A sufficient amount must also be provided in this manner for normal working capital. This may be termed permanent working capital; it constitutes that portion of the funds of a business enterprise which is required from week to week and from month to month. It is the sum needed to carry normal or at least minimum inventories of merchandise and supplies, to provide for the carrying of a

normal or minimum investment in accounts and notes receivable, and to insure that there will be adequate funds on hand to meet payrolls and provide for other operating expense disbursements such as advertising, rental payments, insurance premiums, etc. Certainly, funds invested in a minimum inventory, for example, are no less fixed than those used for the purchase of fixtures or delivery equipment, for they are constantly needed to replace whatever goods are sold so long as it is desired to maintain minimum requirements.

The funds required for long-term investment purposes may be secured through investment by the parties engaged in the marketing operations or through long-term borrowing. Unincorporated enterprises, including the sole proprietorships and the partnerships, make provision for at least a major portion of the long-term capital investment out of their own funds accumulated through savings, or of which they may have come into possession through inheritance, marriage, or other means. Corporations, on the other hand, raise their long-term capital through the sale of securities. To the extent to which stocks are issued for the purpose, the capital is raised through the investment of part owners of the enterprise, since stocks are not credit instruments but merely represent certificates of ownership. Both corporations and unincorporated enterprises resort to the use of investment credit, namely, they secure loans for purely investment purposes through the issue of relatively long-term obligations. These obligations take the form of bonds, real estate mortgages, chattel mortgages, and long-term promissory notes. These are all promises to pay definite sums of principal either in a lump amount or at certain intervals.

While it is *desirable* for a firm to obtain all of its permanent capital requirements from equity or long-term sources, this is a *practical* impossibility for most of them, especially small business enterprises. Consequently, it is rather common to provide for a substantial portion of the permanent capital needed for inventories, accounts receivable, and other assets through reliance upon financial institutions or trade creditors. This can be dangerous, especially when carried to extremes, because the continuance of a business can become too dependent upon the good will of outsiders.

Temporary Financial Requirements. Every merchandising enterprise requires temporary additions to its long-term needs and for a variety of circumstances, the more important of which are discussed below.

Seasonal Fluctuations. Fluctuations in current capital requirements may be accounted for principally by seasonal and cyclical variations. In practically all industries, there are times at which current funds are demanded in very large amounts, just as there are periods in which relatively little capital suffices for the current financial requirements. Purchases of goods for resale are seldom distributed evenly over the twelve months of the year, nor

do seasons of heavy buying necessarily coincide with the seasons of heavy sale. Peak seasons alternating with off-seasons are not peculiar to farming and the construction industries, but are characteristic of all marketing activities even under normal conditions, varying only in degree of influence upon different types of business rather than in kind.

Seasonal conditions of form-utility production or of consumption require large advance expenditures for stock. Wholesale grocers, for example, often purchase a full year's supply of canned goods during the canning season. Retailers of ready-to-wear apparel must concentrate stocks of fall merchandise in the summer in order to show it in advance of the peak autumn selling season. Orders for Christmas toys are usually placed in the middle of the summer and deliveries accepted in the fall, long before the height of consumer demand.

Seasonal variations place an equally heavy burden on business institutions through demands on the part of customers for an extension of credit accommodations. Heavy sales are commonly followed, under such circumstances, by proportionately heavy accounts and notes receivable. The demands become particularly heavy when sales are made on the instalment plan, so much so that special financial institutions have developed to fill the need. Again, during seasons of heavy sales, payrolls may call for such heavy payments as to overtax the normal working capital of the enterprise. It is also not unsound to finance preseasonal advertising campaigns.

The seasonal aspect in marketing and merchandising is sometimes accentuated as a result of unusually slow transitions. When a season is "slow," goods do not sell in quantity until late, thereby tying up some capital in excessive premature inventories. There is also much "frozen credit," because under these conditions purchasers fail to pay their bills promptly, and it is exceedingly difficult to realize on many receivables outstanding.

Cyclical Variations. All businesses are affected by cyclical variations in the level of business activity. Periods of prosperity or recession are usually characterized, respectively, by upward or downward price movements. Purchases are always heavier in anticipation of rising prices and correspondingly light when prices take a downward trend. Similarly, buyers hold off the market during periods of price uncertainty. Even when prices are stable and remain at a given level for any length of time, the needs for current financing will vary with the condition of the times. During recessions there is a general reduction in anticipated purchases, collections become slower, and accounts must be carried for unusually long periods of time.

Other Variations. Aside from these major causes of current financial needs, there are other situations that may require varying amounts of temporary capital. Exceptionally favorable opportunities to purchase goods in larger than usual quantities may present themselves, or it may become ad-

visable to take advantage of lucrative cash discounts by paying merchandise creditors before the bills become due.

Sources of Current Capital Requirements

Most of the temporary capital requirements and varying proportions of the long-term capital needed for investment in current assets are obtained by business firms through the use of relatively short-term credit. This credit may be obtained from commercial banking institutions, other specialized financial agencies, or trade credit sources.

Commercial Banks. Commercial bank credit may be defined as the power that enables commercial banking institutions to attract funds of depositors, to create obligations through the issue of paper money, and to make loans.

Uses of Bank Credit. One of the purposes of bank credit is to make loans to individuals or firms for relatively short periods of time. Sellers borrow from banks in order to help them carry their accounts and notes receivable, while purchasers of merchandise resort to bank loans as a means of securing funds for the payment of bills upon the insistence of creditors or for the purpose of taking advantage of cash discounts. The granting of cash discounts by sellers makes it profitable to borrow from the bank to make cash payments. Furthermore, discounting of bills creates a favorable impression in the trade, improves the purchaser's credit reputation, aids him to become a preferred customer, and obviates the necessity for his dependence upon creditor supply houses. Another use of bank credit, and one that has become common only since the late 1930's, is the financing of purchases of machinery and equipment through instalment loans to business. Such loans are usually secured by a chattel mortgage and are amortized by regular instalment payments, ordinarily over a period of 24 to 36 months or, in the case of very expensive machinery or equipment with a long life expectancy, over periods ranging up to 60 monthly payments.

Limitations to the Use of Bank Credit. An important limitation that often prevents businessmen from relying heavily upon bank credit is the length of the credit period. Except for the instalment loans just noted, this usually varies from 30 to 90 days. The 90-day limitation is rather common because only those notes that mature within such time can be rediscounted by member banks at the Federal Reserve Banks. This limitation applies to all types of commercial paper arising out of the domestic production or trade in manufactured goods. Notes based upon loans for agricultural purposes or those that arise out of foreign trade transactions may be rediscounted through the Federal Reserve banking system even if for longer periods of time. An even more significant reason for the short term of bank credit lies in the

reason for its existence. A commercial bank has the function of helping businesses to carry the peak of the load at the time they are paying for their purchases and waiting for remittance from their own customers. It does not aim to supply permanent working capital, although bank loans are sometimes utilized for that purpose. It is not uncommon for bankers to extend loans to acceptable risks for periods much longer than 90 days, usually by the process of renewal. Since banks, however, desire their customers to clear their accounts at certain intervals, businesses must not place too much reliance upon this source for permanent working capital. Finally, the conservative policies under which banks of necessity operate force them to scrutinize risks with care, as a result of which they frequently refuse to make loans or limit the amount of the loans. Because of these limitations, businessmen often must look to other sources of capital—sources that specialize in financing activities in particular lines of trade or in certain kinds of loans and are therefore more intimately acquainted with the risks and problems of particular marketing institutions.

Factors. Among the oldest of the special types of financial institutions used in connection with the marketing process are factors. They render a financial service of a specialized nature and of a superior quality compared with that of ordinary commercial banks, and thus have made a definite place for themselves. They have given continuous financial support to the textile industry and apparel trades for over a century and a half and have, in recent decades, spread their services to such other lines of trade as paper, glassware, shoes, petroleum, cosmetics, chemicals, furniture, and furs. Variations of the service have also been introduced in the furniture industry and have been extended to manufacturers or wholesalers in still additional lines of trade.

The Services of Factors. The principal service of the factor is that of financing accounts receivable that arise when one business concern sells goods to another on credit. After sales are made, the factor functions by buying or discounting the sales invoices. A seller, in this manner, obtains immediate cash for his production operations and does not suffer from delay in receipt of payment for the goods he sold.

Factors usually make outright purchases of accounts receivables (i.e., purchase without recourse) and thus assume all collection risks and responsibilities. Clients of the factor usually notify their customers that the account has been "factored" and instruct them to make payment to the factoring company. This is normally done by stamping payment instructions on the invoice that is sent to the customer. In some cases, factoring is handled on a "nonnotification" basis. This variation has been worked out for the benefit of clients who do not want their customers to know that the account has been sold to a factor. In this case, the client's customers pay their ac-

counts to him. and he in turn forwards such payments to the factor immediately upon receipt.

For this type of financing service, the factor receives income in two ways. The first is an interest charge based on all advances, usually at the rate of 6 per cent per annum. The second part is a charge or commission that is made for the services of advising clients on the selection of risks and for collecting the accounts when they become due. This service charge, as distinct from the interest rate charged for the use of money, varies from a fraction of 1 per cent to 3 per cent of the face amount of the invoice. Because the money invested in receivables is usually turned over several times a year, the effective rate implicit in the service charge often runs into a considerable percentage figure. For example, if a 2 per cent service charge is made upon an advance that matures within 60 days, the effective annual rate is 12 per cent since there are six 60-day periods in a year.[1] When this rate is added to the first part of the factor's compensation, say an interest rate of 6 per cent per annum, the factor may be able to earn a gross return of approximately 18 per cent upon the capital used in his business. The rates for the service charge are not highly standardized, however, but are a matter of individual negotiation. Considerations of importance in determining the level of the service charge in individual cases are the type of customers involved, whether the factor assumes the risk of noncollection, amounts of money advances, length of the credit period, and the number and kind of other services rendered. It is not uncommon to find factors rendering a type of management consultant service to their clients and assisting in the formulation of merchandising plans and policies.

When Are Factors Used? The factor's financial service is often regarded by his clients as superior to that of the commercial bank, for he advances a larger percentage of the value of the accounts receivable from customers, assumes the risk of credit losses, and takes over much of the routine bookkeeping work associated with a credit department. Wide knowledge of particular lines of business makes it possible for him to do this, also to serve as a valuable and skilled adviser to his clients. Furthermore, his risks are widely distributed, thereby warranting him to assume hazards that might spell ruin to a single manufacturer with only a few customers, each of which required large amounts of goods on credit. In addition, the credit department of the factor prevents frauds and impositions by buyers, who fear to impair their credit standing with this specialized type of banker known to control the credits of a number of possible sources of supply.

Sellers of goods must meet certain qualifications, however, before the factor can be called upon for financial assistance. The client must have a gen-

[1] For purposes of rate per annum calculations, it is ordinarily assumed that there are 360 days in a year.

erally good reputation for reliable merchandise, prompt shipment, and the enjoyment of a good class of customers. The client's customers must be well established and not seriously affected by changes in business conditions or style cycles. The amount and rate of distribution of the client's goods must be steady and predictable. Manufacturers meeting these conditions and in need of current funds for use as working capital may find the factor a convenient and valuable source of direct aid.

Open Accounts Receivable Financing. Factoring, as described above, is to be distinguished from open accounts receivable financing as carried on by banks and other financial institutions. In open account financing, accounts are sold without notification and with recourse, so that the seller retains responsibility for credit-granting, collection, and the risk of credit losses. Another form of such financing consists of promissory notes which are secured by accounts pledged as collateral.

Sales Finance Companies. Sales finance companies such as the General Motors Acceptance Corporation, the Universal CIT Credit Corporation, the Commercial Credit Company, and hundreds of other smaller and less well-known similar organizations are important principally for their activities in financing instalment purchases of automobiles and other durable goods by ultimate consumers. In this connection, their services are discussed in detail in the following chapter which deals with consumer credit.

Many of the sales finance companies also engage in business financing. Some of them purchase open accounts receivable, as described above, and thus provide a service that is similar to that of factors. Another type of financing service that is available from such companies consists of instalment lien obligations in connection with the purchase, by merchants and manufacturers, of items of machinery, fixtures, or equipment that are used in the conduct of business.

One of the principal business financing services of sales finance companies is what is generally known as "floor planning." This is a method of financing inventories of automobiles and other types of high unit value durable goods. The practice may be best illustrated with reference to the automobile industry. Automobile manufacturers normally expect cash payment upon delivery of cars to the dealer. Very few dealers have the capital necessary to keep a large assortment of automobiles in stock. The commercial bank's standards of credit and maturity length of loans have been too strict to be of great value to the average dealer, who has therefore turned to the sales finance company for financial assistance in carrying adequate inventories. Under the floor plan method, the dealer acquires new cars, stores them in a warehouse or displays them in his showroom, and executes a trust receipt for the benefit of the finance company. In this manner, the dealer has physical possession of the merchandise and can display and at-

tempt to sell it, but he does not have legal title to it. Title to the automobiles is vested in the finance company, the dealer merely holding the goods in trust. In some companies, chattel mortgages are used to secure the loans upon cars in storage rather than a trust receipt.

When a sale is made, the proceeds must be immediately turned over to the finance company before the car can be moved from the dealer's premises. In many instances, this is largely in the nature of a bookkeeping transaction rather than a transfer of cash funds, for the same sales finance company often finances the major part of the ultimate consumer's purchase price. The amount loaned to dealers under the floor plan method usually does not exceed 90 per cent of the cost of the article from the manufacturer. The rate of interest charged approximates 0.5 per cent per month or any part thereof, since the risk is comparatively small and the turnover of such loans is fairly rapid.

Financing Through Warehouse Receipts. Every public warehouse issues to depositors receipts for goods placed in storage, and these warehouse receipts are used as a basis for securing advances on the stored goods from commercial banks and, to some extent, also from finance companies. Financing through warehouse receipts has already been discussed at length in Chapter 23. At that point it was also indicated that *field warehousing* is in reality a credit or financing device whereby a warehouse receipt is obtained while the goods are actually in possession of the owner but are legally in the custody of the field warehousing company. While the loans advanced upon goods in storage with public merchandise or field warehousing concerns are usually advanced by commercial banks, the major warehousing companies have a wide acquaintance among banks and finance companies throughout the country and are often able to assist manufacturers and merchants in locating more favorable sources of capital than are sometimes available from local commercial banks.

Mercantile Credit

In the foregoing pages, the activities of various specialized institutions that function in providing business with current capital requirements have been considered. An additional source, and one of paramount importance, is the credit that is obtained from the vendor in the purchase of goods for resale or business use.

Purpose of Mercantile Credit. Mercantile credit is the credit one businessman extends to another when selling goods on time for resale or for commercial use. It includes all postponements of payment involved in the purchase of goods throughout the process of distribution, from the time they are in the state of raw materials until they reach the hands of the retailer. Its

principal purpose is to facilitate the movement of goods through the various stages of production and marketing. Mercantile credit does *not* include credit extended by retailers when selling on time or that extended by manufacturers or wholesale establishments when selling directly to the ultimate consumer.

Terms of Sale. The terms of sale involved in mercantile credit commonly comprise two distinct elements—the length of the net credit period, and the cash discount which is usually coupled with it.

The Net Credit Period. The length of time for which credit is extended is called the "credit period," the "net credit period," or "the free credit period." Wholesalers and manufacturers adjust their credit periods to different lines of business, but great differences are sometimes observed in the same line and even within individual establishments when granting credit to different customers. In general, the length of the credit period tends to conform roughly to the receipt of income, on the part of buyers, from the sale of goods and services. The rate of turnover of the purchaser's stock of goods is the most fundamental and determining factor as to the amount of time involved. In the grocery trade, where high rates of stock turnover are common, wholesalers' terms to retailers often involve only 7 to 10 days and are almost never in excess of 30 days. In the drygoods trade, where the rates of turnover are lower on the average, terms of 60 days are often given to retailers. In the jewelry business, where the average turnover is still lower, terms ranging from 60 to 120 days are commonly granted to retailers.

While the rate of stock turnover is the fundamental consideration, other factors modify this relationship and sometimes obscure it completely. Longer periods are common when customers are located at a considerable distance from the seller, and when goods must be in transit for extended periods. In some instances, the credit period offered to particular buyers is governed by the length of the credit period granted by preceding sellers. If customers of the purchaser receive income seasonally, as in farming areas, or sporadically, as in the case of some mining regions, the retailers' credit requirements are magnified and longer periods in mercantile credit are common.

Cash Discounts. The cash discount is generally granted in the mercantile field whenever goods are sold on credit, as a means of stimulating advance payment of bills. Cash discounts are in a sense interest payments made to buyers for the settlement of accounts before the due date. They are premiums for advance payment, at a rate which is considerably higher than the prevailing rate of interest, because of advantages that accrue to the seller from such a procedure. An illustration of this may be afforded by the following terms which are more or less common in certain lines of trade. Assume

that a bill of goods is purchased on terms of 2/10, net 30 days.[2] This means that if the purchaser pays for the goods within 10 days from date of the shipment or date of the invoice (which are usually synonymous), he will receive a 2 per cent discount to be deducted from the amount billed on the invoice. If, on the other hand, he waits the full 30 days and pays his bill at expiration of the net credit period, he must pay the full amount of the bill. Thus, by deferring payment for 20 days beyond the 10-day period, the purchaser sacrifices 2 per cent of the full amount involved. Receiving a 2 per cent discount for a period of 20 days is the equivalent of earning interest on the amount involved in the transaction at the rate of 36 per cent per annum. This is true because the discount is paid for a period of time which is approximately one-eighteenth of a year.[3]

The seller justifies this discount policy on the ground that it gives him quicker possession of the money, which can be turned over again, and also reduces the credit and moral risks. Immediate possession of the money from the sale of goods tends to increase the rate of working capital turnover, furnishes adequate funds to operate the business, obviates the necessity for elaborate credit and collection machinery, reduces losses from bad debts, and tends to promote a spirit of good will between seller and customer through the elimination of some occasions for friction.

While the cash discount is generally regarded as a premium for payment in advance of due date, it is very often difficult to distinguish it from trade discounts or deductions from list prices quoted to the trade. When large

[2] While terms of 2/10, net 30 are common in some lines of trade, there is a great variety of terms in actual use. The following terms, while not used universally in connection with each commodity specified, are more or less customary in the sale of the goods indicated: bottles, 1/10, net 30; canned goods, 1½/10, net 60; medicine 1/10, net 60; ingots, ½/10, net 30; jewelry, 5/10, net 4 months; flour, 1½/10, net 60; stationery, 2/10, net 60; trade-marked watches, 6/10, net 4 months; teas (importer to wholesaler), 3/10, net 4 months. For a detailed listing of customary terms of sale in numerous lines of trade, see Theodore N. Beckman and Robert Bartels, *Credits and Collections in Theory and Practice*, 6th ed. (New York: McGraw-Hill Book Co., Inc., 1955), pp. 591–96.

[3] The same procedure may be used in order to ascertain the effective rate of interest involved in any cash discount, provided the length of the credit period is known. This may be generalized as follows:

1. Subtract the number of days in the cash discount period from the number of days in the credit period. The result is the length of the period for which the discount is granted.
2. Divide 360 days (the number of days assumed to represent an interest year) by the answer to 1, above. This shows the number of comparable periods in a year.
3. Multiply the answer to 2, above, by the cash discount percentage. The result is the effective annual rate of interest.

This procedure may be illustrated with respect to terms of 3/10, net 60:

1. 60 (credit period) minus 10 (cash discount period) equals 50 days.
2. 360 divided by 50 equals 7.2 such periods per year.
3. 7.2 × 3 per cent equals an effective annual rate of interest of 21.6 per cent.

so-called cash discounts are offered, they are expected to be generally taken. Consequently, the seller prices his merchandise accordingly, so that the true price equals the invoiced price less the portion of the discount which constitutes *in fact* a trade discount.

Limitations to the Use of Mercantile Credit. The degree to which a business purchaser can rely upon mercantile credit as a source of working capital is restricted by *quantitative credit limits* which are imposed by almost all sellers that extend credit to their customers. Quantitative credit limits state the maximum amount of credit that may be allowed to be outstanding on an account. Such a limit represents *an approximate* ceiling that reflects the considered judgment of the selling company as to the amount of credit that may be extended safely to a given purchaser. It is an amount which a careful analysis of the character, capacity, capital, and conditions surrounding the business of the purchaser reveals to be in proper proportion to other aspects of the subject's business. It is the amount, moreover, that the purchaser can be expected to use profitably and to repay in the usual credit period.

There are also other limitations to the use of mercantile credit. Some customers, because of their poor credit standing, may not be able to secure any credit accommodations whatever from their sources of supply, or may be granted exceedingly small amounts and for limited periods of time. There are also vendors who adhere to a strictly cash policy. Finally, the cash discounts offered are usually lucrative enough to warrant buyers to discount their bills. Even when they are not profitable, buyers attempt to discount their bills in order to maintain a good credit standing. All these conditions make it necessary for many firms to secure funds for temporary financing from other sources.

Mercantile Credit Agencies. In analyzing a credit risk, either an active or prospective account, the seller must secure essential information on the risk's character, capacity, and capital standing, as well as on the general business and economic conditions affecting the risk. The most common source for such information is the mercantile agency. In many manufacturing and wholesaling businesses, by far the largest percentage of orders is checked for credit principally or entirely on the basis of information obtained from mercantile agencies through their rating books, special reports or both. Mercantile agencies are institutions formed for the primary purpose of gathering information concerning the credit standing of businessmen and disseminating that information to their subscribers.

By far the best known of the mercantile agencies, and the only one that renders a service that covers many and varied lines of trade throughout the entire country, is Dun & Bradstreet, Inc. The credit service of this company consists of a large number of diversified activities. The company publishes

a reference book which lists and rates some 2,600,000 business firms in the United States and Canada. More detailed information is provided by various types of credit reports which are issued to subscribers upon request. In certain lines of trade the agency also renders a credit advisory service, whereby judgment is offered as to the acceptability of specific orders referred to the agency by clients. A special division of the business operates for the purpose of collecting overdue accounts for clients, both by personal calls and through the mail. In addition to the credit service, this large agency also provides various types of market research, management, and investment services.

While there is only one large and well-known *general* mercantile credit agency, there are numerous *special* agencies that restrict their services territorially or according to lines of trades or types of names investigated. The major functions of most special agencies are similar to those of Dun & Bradstreet, Inc., although each one of the special agencies does not, in all cases, render such a comprehensive service. Among the better known of the special agencies are the Shoe and Leather Mercantile Agency, Inc., the Lyon Furniture Mercantile Agency, the Produce Reporter Company, the Packer Produce Mercantile Agency, and the Lumberman's Credit Association, Inc.

Finance and Marketing

Relation of Finance to Distribution Channels. The financial strength of a vendor has a decided influence upon his channels of distribution. Much of our cotton supply has been marketed through local merchants, primarily because these middlemen have secured a lien on the crop by advancing loans to the growers long before the harvest. Peanuts and many other commodities have been so marketed for the same reason. Canners of fruit and vegetables frequently dispose of their entire output through selling agents to whom they are financially obligated. A similar reason is often advanced for the employment of selling agents in the textile trades although there is a tendency to utilize another marketing specialist, the factor, for purely financial assistance.

Whether or not a firm shall embark upon a method of distribution involving the elimination of the wholesaler or even the retailer may hinge largely or entirely upon the extent of its financial resources. Few producers or manufacturers, indeed, can muster the capital outlay required for the establishment of their own retail stores. Many of them cannot even afford to establish a sales organization that would enable them to sell directly to the retailers, or to maintain the warehouses necessary to furnish prompt delivery. This is one of the important reasons for the utilization of the whole-

saler as a link in the chain of distribution. One reason for the employment of manufacturers' agents is the inability of the sellers to maintain their own sales force.

This problem may be viewed, with results not dissimilar, from the standpoint of the buyer. Relatively few retailers can afford to purchase their merchandise requirements directly from the original producers or from manufacturers. Many retail grocers obtain fruits and vegetables on credit from commission merchants and jobbers, and canned goods and other groceries from wholesale grocers. Other retailers purchase from wholesalers for this and other reasons. Many small manufacturers favor wholesale supply houses because of the ability to secure tools, equipment, or supplies on credit.

Finance and Marketing Policy. Not only does market finance exercise a profound influence upon trade channels, but it also exerts pressure on the adoption of certain marketing policies. Obviously, no marketing institution can operate on a credit basis, whether it be retailer, manufacturer, or wholesale middleman, without adequate financial resources. In the absence of ample capital it may be best to adopt a strictly cash policy. The adoption of brands, manufacturers' or private, is largely dependent upon the concern's financial ability to advertise them effectively and to organize and maintain the proper sales machinery. In selling goods on consignment, financial strength is the most important prerequisite. Other policies, including the rendering of certain services, are equally dependent, in varying degrees, upon the company's financial ability to justify their adoption.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) permanent capital needs
   b) temporary capital requirements
   c) factor
   d) open accounts receivable financing
   e) "floor planning"
   f) field warehousing
   g) mercantile credit
   h) net credit period
   i) cash discount
   j) quantitative credit limit
   k) general mercantile agency
   l) special mercantile agency

2. Explain how the permanent capital requirements of a business enterprise are different from its investment in fixed assets.
3. If you were the proprietor of a department store, what conditions would you encounter that would give rise to varying capital requirements in different months of the year?
4. If you were the principal executive or owner of a wholesale grocery company, what conditions would you encounter that would give rise to varying capital requirements in different months of the year?
5. Why are "terms of sale" discussed in a chapter dealing with market finance?

6. In what ways do considerations of finance influence the channels of distribution that a manufacturer may adopt? Explain.
7. Distinguish between mercantile credit and commercial bank credit.
8. How do you account for such specialized types of financial institutions as factors and sales finance companies in place of a single financial institution like a commercial bank?
9. What is meant by the "net period" in mercantile credit? What factors are important in determining the length of this period, and which of these factors is generally of the greatest significance?
10. How can a seller justify a cash discount policy which rewards or penalizes the credit purchaser to the extent of 30 per cent per annum?
11. Should merchants rely upon short-time accommodations by their creditors for the whole of their working capital? Why or why not?
12. If a firm finds it necessary to obtain additional working capital, what considerations would be involved in deciding whether to employ the services of a factor or to use open accounts receivable financing through a bank or sales finance company?
13. Assume that you have just purchased merchandise costing $8,000 from a vendor who offers terms of 2/10, net 60. If you can borrow money from a local bank at the rate of 5 per cent per annum, would it be profitable for you to borrow to take advantage of this discount? Assume that you can sell the merchandise in question within 60 days and would not need to borrow from the bank for longer than that period. How much would you gain or lose in dollars and cents by borrowing to take advantage of the discount?
14. Calculate the per annum rate of interest involved in each of the following terms of sale:

    a) 1/10, net 90
    b) 5/10, net 30
    c) 4/10, net 120
    d) 1/10, net 30

15. The McGraw Company is a small manufacturer of men's summer suits. It has been experiencing considerable difficulty in expanding its sales volume in line with the market potential. Orders are usually taken from retailers in the early winter and shipments are made about May 1, on terms of net 30 days. Competitive manufacturers have been able to increase their sales volume by earlier deliveries accompanied by extra datings. For example, a leading competitor begins shipments on February 1, but customers are billed as if the shipments had been made on May 1. Such an arrangement would enable the McGraw Company to achieve manufacturing economies by producing suits over a longer period with less overtime work, and it would obviate the need for warehousing, as suits would be shipped as soon as customer orders could be completed. However, the company does not have the financial resources to permit the purchase of materials, incur the cost of manufacturing, and carry accounts receivable from February until about the end of June when retailers would make payments.

    Is there any way in which this difficulty can be resolved?

16. Two partners have organized the Smith Company to be operated as a combination gift and hardware store. They have an option to purchase a suitable store building in a secondary shopping district of a medium-sized city for

$55,000. It is estimated that the necessary store fixtures and equipment will cost about $4,500. Other capital requirements are estimated as follows: cash to meet payroll and miscellaneous expenses, $1,500; inventory, minimum of $30,000, but will run as high as $45,000 during peak months; other working capital requirements, $3,500. The partners have a total of $60,000 that they wish to invest in the business. Assuming that their estimates of financial requirements are sound, outline and explain how you would suggest that the balance of the capital requirements be met.

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MARKET FINANCE: CONSUMER

To facilitate the process of consumption, some goods are sold to the ultimate consumer on credit, or loans of cash are made to him. Some attention has already been given to consumer credit in Chaper 6, where the subject was approached as a factor affecting consumer demand. In this chapter, consumer finance is treated as a marketing function—one which facilitates the flow of goods from the business system into the possession of families or individuals.

Nature of Consumer Credit. The credit granted to ultimate consumers for the purpose of facilitating the process of consumption is known as consumer credit. Theoretically, it is the power which an individual uses in obtaining goods and services, or in borrowing money, for consumption purposes, on the promise to repay an equivalent at an agreed future time. Broadly conceived, consumer credit includes all credit extensions for personal use, whether granted by manufacturers that sell directly to consumers, by retailers, professional men, service businesses, or by the various types of financial institutions.

Reasons for and Basic Types of Consumer Credit. From the standpoint of creditors, there is but one principal reason for credit and that is profit. To the retailer, credit spells increased sales volume and remunerative business; to the money lender, it means a worth-while return on his investment. To the ultimate consumer, however, the matter is not so simple. In general, however, the consumer is prompted to use credit by one or more of three sets of motives: *convenience, a desire for immediate improvement in his standard of living,* and *necessity.* Each of these motives constitutes, in the main, the fundamental explanation for a different type of

consumer credit: *the charge account, instalment sale credit, and consumer cash credit,* respectively.

Importance of Consumer Credit. The importance of consumer credit may be judged appropriately in relation to total retail store sales. Comprehensive data for non-war years, both prior to and following World War II, have revealed that normally about one-third of total retail sales is made on a credit basis.[1] Of total credit sales, about two-thirds are ordinarily charge account sales and about one-third consists of instalment sales. Experience during war years has demonstrated that cash sales become relatively more important at such times. In 1944 and 1945, for example, credit sales declined to about 21 per cent of total retail store sales. The decline during war years is explained principally by the reduced importance of instalment sale credit in periods characterized by scarcities of durable goods.

In addition to charge account and instalment sale credit, there is the matter of consumer cash credit. Unfortunately, there are no satisfactory data available on the total volume of credit granted in the form of instalment or single-payment cash loans to consumers. Such data as are available pertain to the volume of credit *outstanding* at a particular time and measure, accordingly, the amounts due creditors rather than the volume of credit granted during a particular period of time.[2] It is certain, however, that the volume of consumer cash credit that is normally granted *for the purpose of facilitating the consumption* of tangible commodities other than real estate is ordinarily considerably less than the volume of instalment sale credit.

The Retail Charge Account. Consumers utilize charge accounts chiefly because it is convenient for them to obtain goods on that basis. Orders can be placed by telephone, better service can be obtained from stores, several members of a family may buy on an account, home budgeting may be facilitated, and family budgeting may be controlled through monthly payments.

Data for various Census of Business years have revealed that about one-half of the retail stores sell at least some goods on credit, although there are pronounced variations among different lines of business. Practically all non-chain department and clothing stores offer charge account credit, and it is common to find that more than 50 per cent of the sales of such stores represent charge account sales. Only about 38 per cent of the grocery

[1] Data on retail sales by type of transaction are available for Census of Business Years in the Census of Business for Retail Trade. Annual data are available from the yearly "Retail Credit Surveys" of the Board of Governors of the Federal Reserve System and published in the *Federal Reserve Bulletin* for the years 1939–1951.

[2] Data pertaining to the volume of consumer credit outstandings, according to various classifications, are published monthly in the "Consumer Credit Statistics" section of the *Federal Reserve Bulletin.*

stores offer charge accounts, and these are for the most part smaller establishments or independent stores that feature service and high-quality merchandise. Because large volume supermarkets usually operate only on a cash basis, the proportion of total grocery sales made on a credit basis, according to the census data, is only about 10 per cent, although it is over 30 per cent of the sales of the stores selling on credit.

Merchants who operate on a charge account basis do so for several reasons. It is claimed that charge accounts serve to build regular customers who tend to concentrate their purchases and to buy more merchandise. Credit customers are believed to be less resistant to sales and advertising appeals and are more likely to buy on considerations of quality and style rather than price. Stores extending charge account credit also have a more uniform distribution of sales than do cash stores which experience pronounced peaks in business on and following paydays and lulls in activity between such times.

Most charge accounts involve a relationship between an individual retail store and an individual consumer; however, some group arrangements are of interest. In some cities, numerous independent retailers sell on credit through bank charge account plans. Usually a number of stores are affiliated with a given bank; the bank makes credit investigations and approves the accounts; customers may make charge purchases in any of the participating stores; the retailer receives cash for the sale, minus a service charge, at the daily presentation of the sales checks to the bank; and the bank bills the customer monthly for all purchases he made in all participating stores. Major oil companies have promoted the use of credit cards or credit check books which are accepted by any of the independent dealers associated with the company and by the dealers of other affiliated companies. Such group arrangements have made it possible for individual firms to offer charge account services when they would otherwise have found it impossible or uneconomical to do so.

In spite of the advantages explained above, many stores do not choose to make charge accounts available to their customers. If the basic appeal of an establishment is price, all services, including credit, are usually minimized. Charge accounts are not usually used in the sale of goods of low unit value, as in the case of variety stores, where all customers are accustomed to paying cash. Furthermore, merchants with limited financial resources are often forced to operate on a cash basis because charge accounts involve financing consumer purchases for periods of 50 or 60 days on the average.

Instalment Sale Credit

Instalment sale credit differs from charge account credit in one important respect. Instead of paying the full amount of the bill at the end of

a given period of time, the purchaser, when using instalment credit, agrees to pay his obligation in fixed portions or instalments at stated intervals. Other common, although not universal, distinctions are that a down payment is required on instalment transactions and that a finance charge is levied on the unpaid balance.

Present-Day Importance of Instalment Credit. Although it is an old business practice, the instalment method did not evoke much attention until about the middle of the 1920's when its use was greatly extended together with the expansion of the automobile market. During the 1930's the method became more common as it was extended to numerous types of durable goods and even to "soft" goods which have been later sold extensively on deferred multiple payment plans. Furthermore, it has become more important as it gained respectability; the plan has been accepted not only by the poor who lacked the wherewithal for immediate purchases, but also by the well-to-do who wished to buy expensive items out of future income without disturbing current investments.

Instalment sale credit accounts for about one-third of total credit sales of retail establishments in non-war years. During war years and periods of national emergency marked by scarcities of durable goods, the total volume of instalment sale credit has been as little as one-fourth of total credit sales and as low as less than five per cent of the total sales of retail establishments. Approximately two-thirds of the *instalment sale* credit extended annually represents automobile financing. Other lines of business in which instalment sale credit is of great significance are furniture stores, household appliance stores, jewelry stores, automobile tire and accessory stores, and department stores.

Sales Finance Companies and Instalment Sale Credit. Finance companies are of two types: *personal finance companies* engaged chiefly in making cash loans and which are discussed at a later point, and *sales finance companies* engaged principally in financing the sale of goods.[3] Sales finance companies finance automobiles, radios, television receivers, washing machines, and many other durable commodities. Most of the companies, however, do the bulk of their business in connection with automobile financing and have been closely identified with the expansion of the automobile market. It is appropriate therefore to illustrate their operations by giving major attention to automobile financing.

[3] Sales finance companies are typified by General Motors Acceptance Corporation, Universal CIT Credit Corporation, and the Commercial Credit Corporation. In addition to these nation-wide firms, there are hundreds of similar regional or local sales finance companies. While sales finance companies are engaged principally in financing the sale of goods, many of them also make cash loans to consumers and to that extent are similar to personal finance companies.

Method of Operation.[4] When an automobile is sold on the instalment plan (and the same applies to other articles financed by sales finance companies), a promissory note covering the transaction is made out by the purchaser. The note, secured by a chattel mortgage on the car, or by a conditional sale contract, is indorsed by the dealer, with or without recourse, as the case may be, and is then discounted by the finance company. Prior to acceptance of the risk by the finance company, a credit investigation is made in order to determine the purchaser's willingness and ability to meet the instalments when due. An agreement must be reached on the amount of down payment and the number of, and the amount of time between, instalment payments. On automobiles, the usual down payment required has, from time to time, varied from about 10 per cent to 15 per cent to one-third of the purchase price; the time interval between payments is generally one month; and the number of payments has varied from about 12 to 36.

In determining the amount to be paid under the instalment sales contract, a regular service charge is added to the unpaid balance. This charge, which is all too often confused and compared with pure interest rates, must cover interest on the money lent, credit and collection expense of the lending agency, a reasonable allowance for bad debt losses, allowance for expenses involved in repossession, reconditioning, and sale of cars of delinquents, and certain types of insurance as specified. This charge is quoted in terms of *nominal* simple interest percentages, i.e., the amount of service charge expressed as a percentage of the total amount borrowed on a per annum basis, i.e., on the total initial unpaid balance. The *actual* effective rate of interest is generally about twice the nominal rate because the borrower is constantly decreasing the outstanding balance by monthly payments made throughout the loan period. A method of computing effective rates of interest on instalment purchases is presented in an appendix to this chapter.

Other Applications of Instalment Sale Credit. Instalment credit is generally used in many types of retail stores that operate without assistance from sales finance companies. Department stores, mail order companies, furniture stores, and home appliance stores are some of the major types of establishments that maintain their own instalment credit departments, make credit investigations, and handle collections, which are accepted at accounts receivables offices in the store or are made by consumers by mail. Many of these stores finance their receivables through commercial banks or other financial institutions.

[4] For a more detailed discussion of the operations of finance companies, see T. N. Beckman and R. Bartels, *Credits and Collections in Theory and Practice,* 6th ed. (New York: McGraw-Hill Book Co., Inc., 1955), chap. vii.

Durable goods items of high unit value are usually sold on straight instalment contracts which customarily involve a down payment and payments of a specified amount for a definite number of weeks or months. Since about the middle 1940's, various types of "budget" or "revolving" credit plans have been adopted extensively by department stores and apparel retailers, to facilitate the sale of soft goods on instalments. According to the most common arrangement, the consumer contracts to pay a certain amount each month and thus is granted a credit limit which is a multiple of the monthly payment. In a 12-month revolving account, if the customer contracts to pay $20 per month the credit limit is set at $240. The consumer can make purchases of any kind of goods sold by the store, so long as the credit limit is not exceeded. Each month a carrying charge, usually 0.5 or 1 per cent, is added to the outstanding balance. Consumers who cannot handle large purchases on ordinary charge account arrangements find it feasible to use such accounts to spread payments over a number of months. Retailers have found that such accounts have made it possible for them to expand the market for better classes of merchandise, and the monthly carrying charge is often a welcomed source of interest income.

Instalment selling has also been applied to the marketing of various kinds of services. Most airlines, for example, have made it possible for consumers to take expensive vacation trips which are financed over a number of months. Similarly, many doctors, dentists, and hospitals have made arrangements with financing institutions so that people with limited incomes may finance major medical expenses on definite instalment arrangements.

Arguments in Favor of Instalment Credit. The real nature of instalment credit can be but little understood merely from a knowledge that it involves periodic payments. Instalment credit is not merely a technique; rather it is a pervasive influence and an explanation of its nature must be sought in the effects it has upon all whom it touches. These effects are reputedly both beneficial and detrimental.

The advantages of instalment credit may be considered from the standpoint of the business establishments that use it as a selling technique and from the point of view of society in general. To merchants selling goods on the instalment plan, it is not a matter of conjecture that the plan tends to increase sales volume. It does increase the total demand for goods of the type that may be sold on this plan, as is shown below, and it brings people into the store at frequent intervals to make payments. Each such call gives the store an opportunity to make additional sales, with payments for one purchase leading to still additional purchases and greater familiarity and more intimate dealings with the credit-granting establishment.

From the standpoint of society, the instalment plan is desirable, first, because it *enables people to obtain, without delay, many commodities of high unit value and much usefulness,* without the necessity of waiting for long periods before they are acquired, or of doing without them altogether. The buyer is thus enabled to use the article while paying for it; as a result he can enjoy life more fully than would be possible without instalment buying.

A second social advantage, and one contrary to much popular opinion, is that instalment buying *tends to encourage thrift.* It is an enforced form of saving, *provided* that the terms of payment are such that the consumer's equity in the purchased article is increased at a rate greater than the rate at which the article is used up or consumed. People will economize in order to be able to meet instalments when they come due, even though they may be unable, or lack the discipline, to economize merely for the sake of accumulating money for future use. Instalment buying tends to discourage the waste or dissipation of funds on expenditures for goods or services that afford only immediate and short-lived satisfaction. It is an effective method of setting aside funds so that higher priced needs and comforts of life may be obtained.

Third, *because instalment credit has widened the market for the type of consumer goods sold in this manner, it has contributed to lower prices on such goods.* Most of the industries manufacturing durable goods of high unit value operate on a decreasing cost basis; consequently, as their output is increased, the unit cost is materially reduced. The advantage of lower prices resulting from market expansions attributable to consumer credit inures to the benefit, therefore, of cash and credit customers alike.

There can be no doubt, furthermore, that instalment credit *has contributed to a substantially higher standard of living for large segments of the consuming public.* This argument is a natural corollary of the two just stated, in that it results both from the savings feature of the plan and the broadening of the market through price reductions of many types of goods. Standards of living are judged in large measure by the number and kinds of durable goods and costly articles in the possession of consumers, as well as by the consumption of items yielding cultural and aesthetic satisfaction. Much of the income that is now used for purchasing automobiles, television, radios, dishwashers, washing machines, garbage disposals, vacuum cleaners, floor coverings, furniture, and refrigerators would be expended upon highly perishable satisfactions in the absence of instalment credit. Furthermore, in the absence of economies of scale enjoyed by industries manufacturing such goods, unit prices would necessarily be much higher and at such a level that it would be impossible for the masses to purchase items of this kind. The instalment plan has thus aided people in attaining higher standards of living, and the added responsibility often

causes them to do more and better work, for in order to meet these instalments they often must earn more.

Objections to the Instalment Plan. Instalment credit is sufficiently well established as a business practice that it is only upon rare occasions that objections to it arise from within the business community. Some strong arguments have been set forth against it, however, by those who view the subject from a consumer or social standpoint. Most such objections are either made by those who have no understanding of this type of credit, or objections are directed to abuses rather than to sound applications of it.

Among the most common criticisms is that it causes people to live beyond their means by the consumption of luxuries to which they are not entitled on the basis of current income. Tastes and desires of different individuals vary so much, however, as to make any attempt to dictate that one commodity be purchased instead of another, or that it be bought on a certain basis, the height of absurdity.

A second and somewhat related objection is that instalment credit has led consumers to mortgage their future incomes, both through the consumption of luxuries and overconsumption in general, to the extent that the slightest interruption in normal earnings would effect a very serious and straitened condition in their ability to meet obligations. Such criticisms are apparently based upon two assumptions: (1) that a person's income is static and (2) that instalment purchases are made on top of what would be normally bought in the absence of such purchases. In numerous individual cases, the person who bought an expensive article on the instalment plan may justly expect an increase in his present earnings during the life of the contract. Again, he may so reapportion and redirect his purchases that less of other types of goods will be bought, or he may have been saving to the extent that this distribution of his income can be modified without impairing his security. Furthermore, many buyers on the instalment plan have resources other than their immediate income, which can be converted into cash if desired or necessary in order to meet obligations. On the other hand, when the volume of consumer instalment indebtedness is increased at a very rapid rate through an excessive liberalization of credit terms, the future incomes of many persons become mortgaged to an undesirable degree, and such persons are taken out of the market for other normal purchases in future years. This occurred in 1955 in connection with unusually aggressive promotion of automobile sales through credit-term competition. One of the largest sales finance companies reported that the proportion of its instalment paper accounted for by terms of 31 to 36 months was only 5 per cent in 1953, only 10 per cent in 1954, but increased to 33 per cent in 1955.[5] Such a situation inevitably gives rise

[5] "In a Boom Built on Credit," *Business Week*, March 10, 1956, p. 61.

to serious doubts about the soundness of credit-granting practices and raises major questions about the ability of many consumers to retire their indebtedness in accordance with contract terms should any reduction in income be suffered.

One of the most serious objections to instalment credit is its costliness. In operating on a charge account basis, there is but one collection to be made for purchases during the credit period and, ordinarily, only one chance that payment will be delayed or not made at all. From the standpoint of the store or finance company, there are repetitive chances that the instalment purchaser will become delinquent. Elaborate collection machinery must be established to insure that payments are kept forthcoming and that the purchaser remains satisfied with the goods and the service of the selling establishment. In addition to collection expenses, carrying charges must also include, as previously indicated, interest on the funds used, bookkeeping and clerical costs, credit investigation expense, reserves for bad debt losses, and allowances for the cost of repossession and resale of articles.

An objection voiced by many is that charges are exorbitant, i.e., even greater than warranted by actual costs of carrying instalment accounts. This criticism arises in part from misunderstanding and in part because certain less reputable vendors have taken advantage of the ignorance of some consumers. All too often the carrying charge on instalment purchases is inappropriately related to the economic concept of interest which involves merely a price paid for the use of money. Learning that the actual rate of instalment charge per annum on a given transaction is, for example, 12 per cent per annum, a consumer may unrealistically compare this rate with the rate of interest, say 2 or 3 per cent, that his funds will yield if deposited in a savings account. The conclusion may be drawn that the charge is exorbitant, without cognizance of the fact that interest is only a fraction of the total cost, as detailed in the preceding paragraph, that must be recovered in the service charge on the instalment transaction. In other cases, the charge of exorbitance results from the practice of certain vendors who do not quote any percentage rate of instalment charge, but emphasize in the sales presentation merely the amount of the down payment and the amount of the periodic payments. Apparently there are many consumers who are unable or too indifferent to figure the cost of purchasing on the instalment plan at the time purchases are made if the amount of the monthly or weekly payment is something they feel they can reasonably afford. Consequently, certain stores have been able to make very high charges on instalment transactions and under such circumstances that the amount of the charge is not actually known by many customers. Fortunately, this is a practice that has never been common among more reputable dealers. In fact, few consumers know just how to determine the

actual rates paid by them on a per annum basis, and yet such knowledge is indispensable in making intelligent comparisons with respect to alternative methods of financing goods that may be purchased on the instalment plan.

A fifth important criticism of instalment credit is concerned solely with *abuses* of instalment credit as, for example, when carrying charges are not disclosed or are misrepresented. Many vendors and finance companies have quoted only nominal rather than actual rates per annum and, even so, have failed to indicate whether the rate applied to the unpaid balance after the deduction of the down payment or to the full purchase price of the article. With respect to this criticism, it is significant that steps have been taken in the direction of regulation relating to the use of clear forms of instalment sales contracts permitting consumers to know what they are paying and how the terms compare with those offered by competitors. Such regulation, while at present greatly limited in relation to the apparent need for it, should, if extended, minimize misrepresentation in the future. The nature of the regulation currently in force is discussed in another section of this chapter.

Cash Credit as a Supplement to Instalment Sale Credit. Consumer cash credit may be distinguished from instalment sale credit in that consumers obtain cash funds, rather than merchandise, in exchange for a promised future repayment. A large proportion of such credit has its origin in human want and misery and is explained by the urgent need for immediate funds in order to cope with emergency situations. To an important extent, however, cash credit is a supplement to instalment sale credit; and in this respect it is of great significance as a factor in the marketing of goods. There are numerous instances in which a consumer has a choice as to the type of credit he might use. For example, in buying a major electrical appliance, he might make the purchase on the instalment plan, arranging for payments with the store from which the purchase is made. On the other hand, he might obtain a cash loan from a lending agency, pay cash to the store selling the merchandise, and repay the loan to the lending agency in periodic instalments. In some instances, the latter procedure may be used to circumvent the down payment that is required by the store selling on the instalment plan. There are no statistics that reveal the extent to which cash credit directly supplements instalment sale credit and to what extent it is used for emergency purposes arising out of unforeseen events or from past financial mismanagement. That cash credit is of considerable significance in facilitating the sale of goods is, however, generally recognized, both by marketing authorities and by those engaged in the cash-lending business. Accordingly, brief consideration of some of the important sources of consumer cash credit is pertinent to the study of marketing.

Personal Finance Companies. Personal finance companies operate under provisions of state laws (the Uniform Small Loan Law discussed at a later point), under which they are licensed and regulated with respect to size of loan, charges thereon, and certain lending practices. Such companies frequently operate on a sectional or national scale, with branch offices in cities of all sizes, each office constituting a separate licensee.[6] It is believed that these companies serve in the neighborhood of 2,500,000 families each year, principally skilled and semi-skilled laborers and office and clerical workers. Most of the companies make "character" loans, without co-signers or security, occasionally in amounts up to $1,000 to worthy credit risks. Some of the companies aid borrowers in budgeting their expenses to make sure that they will be able to extricate themselves from financial difficulties. In this connection, some of them have also taken the responsibility for educating clients on buying so that they may get their money's worth and live within the family income. Rates charged appear to be reasonable when related to the type of service rendered, and in the larger population centers where the volume of business permits it, such rates are usually lower than the maximum permitted by law.

Industrial and Commercial Banks. So-called "industrial" or Morris Plan banks were originally established as a service to industrial workers to obtain loans that were repaid by "deposits" made into a fund that was allowed to accumulate until the amount of the loan could be repaid in entirety. Such loans, which average around $700, usually require a responsible co-signer. The development of these banks in the early part of this century is attributed to the lack of sources for consumer cash credit. With the advent of personal finance companies and the expansion of personal loan facilities by commercial banks, most of the present-day industrial banks have simulated the general character of one or the other of these types of organizations.

Since the 1930's commercial banks have played a role of ever-increasing importance in consumer finance.[7] In the personal loan departments of many commercial banks, much larger instalment loans are made to consumers than are ordinarily accepted by personal finance companies. Possibly because of their traditional conservative nature, banks have confined their business to a higher class of credit risks than accepted by personal finance companies and often require some type of collateral. Rates vary with the type of borrower, the purpose of the loan, and the length of time for which the loan is desired. Nominal charges of 6 to 8 per cent of the amount borrowed are common which amount, on instalment loans, to effective

[6] Among the better known personal finance companies are the Household Finance Corporation, Personal Finance Company, and the City Loan Company.

[7] In 1939, commercial banks held 24 per cent of the total consumer instalment debt outstanding at the end of the year. By the end of 1956, they accounted for about 38 per cent of the total. *Federal Reserve Bulletin,* December, 1956, pp. 1352–53.

rates of about 11 to 15 per cent per annum, assuming no special charges for investigation or penalties for delinquency.

Control of Consumer Credit

As consumer credit has grown in stature during the course of this century, it has led to ever-broadening concepts of its social and economic significance. Consumer credit, particularly of the instalment sale or instalment cash type, has been, accordingly, the subject of increasing control and regulation by state and federal government. This control is of two types. The earlier regulatory measures, primarily on a state basis, dealt with the *quality* of credit to be made available to consumers. More recent controls, under the name of the federal Regulation W, deal with the *quantity* of credit to be made available for this segment of the economy. While the earlier measures were designed to affect nothing but the field of consumer credit itself, the later federal regulations constitute a device for accomplishing other economic and social ends.

Quality Control. Regulations pertaining to the quality of consumer credit are designed to prevent usurious, deceptive, unfair, or monopolistic practices by credit-granting agencies.

The Uniform Small Loan Law. At the beginning of this century, many consumers in need of cash funds were forced to look to illegal lenders or "loan sharks" as a source for loans, and had to pay exorbitant rates. The reason for this was that the usury laws of most states limited interest rates to 6 per cent per annum or, in the presence of a special contract, to 8 per cent. Such rates were inadequate to attract agencies to make consumer loans in small amounts at inevitable high costs. After making a thorough study, the Russell Sage Foundation, a philanthropic organization working for the improvement of social conditions, drafted a model bill for submission to state legislatures in 1916. This Uniform Small Loan Law, has subsequently been enacted, in some cases with modifications, in 37 states.

The main provisions of the law permit specially authorized interest rates on loans up to $300. An interest rate or charge of 3½ per cent per month on unpaid balances of $100 or less and 2½ per cent per month on the remainder up to the $300 limit is recommended.[8] The law provides that no special fees may be collected on the loans, nor may any charges be made

[8] The provisions here stated are those of the uniform law as recommended by the Russell Sage Foundation. Numerous variations are to be found in the legislation of some states that have enacted the law with modifications. In some instances, provisions for loans up to $1,000 are made, but the higher than legal rates apply only to the maximum small loan part thereof which is usually limited to $300 although the tendency has been to raise it to $500. In some states, interest rates are graduated, decreasing with the size of the loan.

other than the rates applying on the unpaid balance. Companies operating under the law are licensed and bonded and are subject to state inspection.

State Regulation of Retail Instalment Financing. State laws concerning the control of retail instalment selling and financing were first enacted in the middle of the 1930's and have been passed in a total of some 12 states.[9]

There is considerable variation in the provisions of these state laws now in force. Some pertain solely to automobile financing, whereas others cover all kinds and types of instalment sale credit. Practically all of them are intended to combat excessive finance charges and nonprice abuses by requiring instalment sellers to provide written contracts that give a dollar itemization of the following: commodity price, down payment, finance charge, and insurance and/or other charges, if any. In California, Indiana, Ohio, and Pennsylvania, the present laws contain specific provisions pertaining to maximum allowable finance charges.[10]

FTC Regulation of Instalment Financing of Automobiles. The broadening interest in the quality of available instalment sale credit is also evident from a code of fair trade practices covering certain aspects of automobile sale financing. Rules promulgated by the Federal Trade Commission as of May, 1951 prohibited certain practices including: (1) false, misleading, or deceptive statements concerning insurance coverage or rates, plans respecting methods of financing, or financing costs or rates; (2) failure to furnish the buyer with a written itemization disclosing the complete delivered cash price of the automobile, the amount credited as a down payment or trade-in, the time balance (amount of credit), the cost of any insurance included in the contract, the amount of the finance charge, and other charges, if any, entering into the total consideration to be paid by the buyer to the seller; (3) having the purchaser sign a contract in blank, to be filled in subsequently by the seller or financing institution with the purpose or effect of deceiving the buyer; (4) false or misleading use of rates or rate charts for the purpose of misrepresenting the finance charge; and (5) requiring the placing of insurance by the seller or financing institution as a condition of sale. These prohibitions apply, of course, only to companies engaged in interstate commerce and subject to the jurisdiction of the FTC.

[9] These states, together with the dates of enactments, are as follows: Indiana and Wisconsin, 1935; Massachusetts, 1937; Maine and Michigan, 1939; Maryland, 1941; New York, 1942; California, 1945; Connecticut and Pennsylvania, 1947; New Jersey, 1948; and Ohio, 1949. For a detailed analysis of the provisions of these laws see Wallace P. Mors, "State Regulation of Retail Instalment Financing," *Journal of Business of the University of Chicago,* October, 1950, pp. 199–218; and January, 1951, pp. 43–71.

[10] In California and Pennsylvania, such provisions apply only to automobile financing. In Ohio and Indiana, methods of determining maximum finance charges are specified for all retail instalment sales.

Quantity Control. The first attempt to control the quantity of consumer credit to be made available by the economy grew out of the World War II emergency. Under wartime powers, the President, on August 9, 1941, issued an executive order giving the Federal Reserve Board authority to restrain consumer credit. As a result, Regulation W was issued to place limitations upon the use of instalment credit and later also on charge accounts.

Regulation W was not intended as a means of improving business practice in the credit field and thus maintain or increase the soundness or quality of the outstandings, but rather as a device to restrain the *quantity* of credit in order to meet a two-fold need in a period of economic emergency. On the one hand, there was a need to prevent inflation—to hold price increases resulting from scare buying and other inflationary wartime pressures inherent in a dwindling supply of civilian goods. On the other hand, there was a need to conserve scarce materials used in the manufacture of durable consumer goods and to direct them into defense or war production.

These ends were to be attained by Regulation W principally through requirements concerning down payments and maximum maturities of instalment credit transactions. The first requirement was that down payments for automobiles and most other durable goods should not be less than one-third of the cash price; on pianos and furniture, a down payment of only 20 per cent was required. Second, throughout most of the Regulation's effective history, the maturity of instalment sale contracts was limited to 12 months, except in the case of automobiles and motorcycles, for which the limitation was 15 months.

World War II Regulation W expired in November, 1947, following which instalment sale terms were considerably liberalized by merchants. At the urgency of the Federal Reserve Board, the Regulation was reimposed by an act of Congress in August, 1948, and remained effective until this authority expired in June, 1949. Following the outbreak of the Korean emergency by the middle of 1950, Regulation W was again reissued under the authority of the Defense Production Act of 1950 and remained in effect until May, 1952. Since 1952, much discussion has been devoted to the desirability of employing credit controls as a counter-cyclical business regulator, even in peacetime years.

The wisdom and efficacy of this type of credit regulation are subject to serious questioning. If inflation or undue business expansion is to be controlled through restraining instalment credit, this action must rest upon the assumption that such credit is an extremely vital factor in the economy, even more so than mercantile credit which is to remain free of such regulation. This is extremely doubtful. It is further assumed that such credit is highly inflationary, which is debatable. Finally, it is assumed that regulation of the W type is effective, an assumption that is yet to be proven by an impartial examination of the facts.

APPENDIX: Calculation of Interest Rates or Effective Annual Rates of Charge in Instalment Transactions

So numerous have the forms of instalment sale and cash credit become that the consumer now has several choices at his disposal. In order to make intelligent choices among these alternative opportunities, it is often necessary to ascertain the actual rate charged on an instalment transaction.

Determination of Actual Annual Rate of Charge. The calculation of the actual rate of charge per annum involves a relatively simple determination of the relationship between a *nominal* rate of charge expressed in relation to the total amount of credit obtained (i.e., the original or initial unpaid balance) and an *actual* or true rate paid on a constantly decreasing outstanding principal. The fundamental simplicity of the basic relationship is often obscured by the variety of ways in which the instalment charges have come to be expressed. While there are many ways in which the rate can be worked out, for most purposes it may be computed most easily by the five steps discussed below. These steps may be best explained in terms of a simplified concrete example, as follows:

A washing machine is offered for sale on the following terms: cash price, \$200; down payment required, 25 per cent; balance payable in 18 monthly instalments of \$9.50 each.

1. Determine the Amount of Credit Required: The first question is: How much credit was extended by the seller to the buyer? Stated in another way, the question is: How much money did the buyer lack for a cash purchase? This can always be determined by subtracting any down payment from the cash purchase price of the commodity. In the present example, the cash value of the article is \$200 and the down payment is \$50. Thus the amount of credit required, or the amount borrowed by the purchaser, is \$150. It should be noted here that the purchaser does not *borrow* the instalment charge; rather, the charge is made for the privilege of buying on credit.

2. Determine the Cost of the Credit Required: The second step involves a determination of the total cost incurred by the instalment credit transaction. The relevant question is: How much more must be paid in total on the instalment plan than for a cash purchase? In this illustration, the down payment is \$50, and the amount to be repaid on instalments is \$171 (18 × \$9.50). Thus the total cost on the instalment plan is \$221 (\$50 + \$171). This is \$21 more than is required for a cash purchase. Accordingly, the cost of buying on instalment credit is \$21.

3. Ascertain the Nominal Rate of the Credit Charge: This rate expresses the relationship between the instalment charge and the amount of credit obtained. The question is: What is the cost of the credit as a per cent of the

amount borrowed? In the case in question, the cost of the credit ($21) is 14 per cent of the amount of credit obtained ($150).

4. *Compute the Nominal Rate Per Annum:* Frequently the credit extended is used for shorter or longer periods than a year and the rate of charge (nominal or actual) has no meaning until it is stated in terms in common use, namely, as an annual rate; i.e., on a per annum basis. This is derived by dividing the nominal rate as obtained in step 3 by the time involved (months or weeks) and multiplying by the number of such units in a year. In this illustration, when 14 per cent is divided by 18 months, the rate per month is 0.778 per cent; when this monthly rate is multiplied by 12, the annual rate of 9.336 per cent is obtained.

5. *Convert the Nominal Annual Rate into an Actual or True Annual Rate:* Because the amount of credit in use is reduced each time a payment is made, the nominal rate per annum does not reveal the true relationship between the amount of the instalment charge and the average amount of credit in use. The conversion of the nominal annual rate to an actual rate per annum may be accomplished by the following formula:

$$R = \frac{r\,(2n)}{(n+1)}$$

In this formula, R is taken as the actual annual rate of interest charged, r stands for the nominal rate per annum as determined in step (4), and n represents the number of instalments required to repay the principal. The logic of this formula is based on the fundamental proposition that a contract to pay one-twelfth of a given sum at the end of each month for 12 months is equivalent to a contract to pay the entire amount at the expiration of 6½ months (one-half of the number of instalments and one-half of another instalment), since each month that a payment is made the amount outstanding for the remaining period is reduced. Thus, in the present illustration, the actual rate per annum is calculated as follows:[11]

$$R = \frac{9.336\%\ (2 \times 18)}{(18+1)} = \frac{9.336\% \times 36}{19} = \frac{336.096}{19} = 17.69\%$$

[11] A number of other methods and formulas have been developed as short cuts in ascertaining the actual annual rate on instalment transactions. One of the best known of these formulas is the following:

$$R = \frac{2\ (\text{Payment periods in year}) \times (\text{Total amount of finance charge})}{(\text{Original unpaid balance}) \times (\text{Number of payments} + 1)}$$

This formula yields the same results as the procedure outlined in the illustrations given in the text. It is subject to the disadvantage that it does not reveal the logic involved. Furthermore, if the terms express the charge as a per cent, such charge must first be converted into an amount, in dollars and cents, before applying this formula. On the other hand, if the charge is stated as a per cent of the credit extended, this percentage may be used directly as the answer given to step 3 in the procedure outlined in the text.

A Second Illustration. In some transactions the calculation is somewhat more simple and self-evident because the answers to various of the questions implied by each of the foregoing steps are given in the statement of the case. For example, assume that a consumer obtains a cash loan of $500 from the personal loan department of a bank and is told that he must repay this by making 24 monthly payments of $24.33 each. The calculation of the actual annual rate, in accordance with the foregoing steps, is as follows:

1. The amount borrowed is given as $500.
2. The cost of the credit is the difference between the amount borrowed and the amount to be paid. The amount to be paid is $583.92 ($24.33 × 24). Hence the cost of the loan is $83.92 ($583.92 − $500).
3. The nominal rate for the period of the loan is 16.78 per cent which is determined by dividing $83.92 by $500.
4. Since the loan is for two years, the nominal rate per annum is 8.39 per cent (16.78 per cent divided by 2).
5. The actual rate per annum is calculated as follows:

$$R = \frac{8.39\% \ (2 \times 24)}{(24 + 1)} = \frac{8.39\% \times 48}{(25)} = \frac{402.72}{25} = 16.09\%$$

Questions and Problems

1. Briefly explain the meaning of each of the following:
   a) personal finance companies
   b) sales finance companies
   c) Regulation W
   d) consumer credit
   e) nominal rate per annum
   f) actual rate per annum
   g) Morris Plan banks
   h) industrial banks
   i) "revolving" credit plan
2. What are the principal reasons that account for the existence of consumer credit? Explain how each reason is related to a particular type of credit.
3. From the standpoint of the merchant, what advantages are generally associated with charge account credit? If these advantages actually exist, how do you account for the presence of the numerous "cash only" retail stores and for the fact that about two-thirds of all retail sales are ordinarily cash sales?
4. What is meant by the statement that "cash credit supplements instalment sale credit"? Explain and illustrate.
5. How does "quality control" differ from "quantity control" of consumer credit? Explain.
6. It has been claimed by many that instalment sale credit encourages people to incur indebtedness beyond all possible means of repayment and, accordingly, leads ultimately to misery. Should we therefore abolish consumer credit?
7. The authors maintain that consumer purchasing power and total consumer demand are limited ultimately by the flow of disposable personal in-

come and not by the existence or lack of instalment credit. How then can the argument be advanced that instalment credit raises living standards?

8. Many have criticized instalment credit because charges are exorbitant and because charges are misrepresented or stated in such a manner that the consumer cannot determine how much is being paid for the use of such credit. Is this criticism valid? If you can see any validity in the claim, can you see any indication that there will be less ground for such criticisms in future years?
9. Executives of personal finance companies claim that their charges should not be construed as "interest." Is there any sound basis for such a contention? Explain.
10. Are consumers better off when interest rates are kept low by law or when higher rates may be legitimately charged? Explain.
11. In a certain department store, the instalment credit charge is ½ of 1 per cent per month on the original unpaid balance. What is the actual rate per annum?
12. A small $45 radio is offered for sale on these terms: "Pay nothing down and only $1 per week." An inquiring prospective purchaser learns that he must make 52 such weekly payments. What actual per annum rate is involved?
13. A washing machine was offered for sale on the following terms: cash, $135; instalment price, $148.50; down payment required, 10 per cent of instalment price; balance payable in 18 equal monthly instalments. What is the actual rate per annum in this case? Under a Regulation W, if such should exist, what major provisions are violated by these terms?
14. The total delivered cash price for a certain automobile, including all accessories and taxes, is $2,190. In purchasing this car, a consumer is given a trade-in allowance of $1,100 on his old car. The balance is to be paid in 15 monthly instalments of $78 each. What is the actual rate per annum?

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MARKET RISK AND SPECULATION

The assumption of risk is an important function that must be performed by all types of middlemen, manufacturers, and original producers in the agricultural and extractive industries. In addition, there are numerous specialists in risk-bearing, known as speculators. A number of types of risk which are of especial interest to those engaged in marketing are considered in this chapter; also included for the sake of completeness are some other types that are common to all business. The discussion of risk is continued in the following chapter, in which attention is devoted to the practice of shifting certain types of risks to speculators through the process of *hedging*.

Classification of Market Risks. Market risks may be classified according to their cause or character into five groups, as follows:

1. *Physical destruction or deterioration* of commodities or other properties which may result from natural causes such as windstorms, floods, earthquakes, drought, or unseasonably cold or hot weather, or from controllable causes such as inadequate safeguards against fire, vermin, or freezing
2. *Theft,* including fraud or pilferage by employees, burglary, or shoplifting
3. *Personal contingencies* relating to accidents or sickness of employees, death of key executives, or, especially in small companies, of key salesmen who account for a large proportion of a firm's sales volume
4. *Credit extensions* which involve the risk that debtors may be unwilling or unable to meet their obligations at maturity or ultimately
5. *Market conditions* which involve risks arising out of uncertainty about the exchange value of commodities

Of these classes, the most significant risks are those which arise out of market conditions. They may be divided principally into *time risks* and

place risks. Practically all marketing transactions involve a certain degree of hazard due to changes wrought by the passage of time. Merchants buy goods with the hope of reselling them at a profit; manufacturers attempt to produce commodities that will sell at some future time at remunerative prices; farmers raise what they think will be in demand. But markets for certain commodities may be glutted; the wants of consumers may change, as is true of all style goods; or seasonal changes may be too slow or otherwise unfavorable. Any of these changes may affect the demand for and supply of any commodity one way or another, with a resulting increase or decrease in risk. Place risks are practically present and are incurred when a commodity is offered for sale, or a purchase must be made, in an unfavorable market. Special losses may result in this connection from misjudgment as to a proper market. This is often true of perishable fruits and vegetables when, because of a lack of adequate information on the part of shippers, they are forwarded to a glutted market where they must be sold without delay in order to prevent physical deterioration.

Methods of Minimizing Market Risks

There are two general methods of minimizing market risks. One is to *lessen the chance of their occurrence,* through good management practices. The other involves *shifting risks to others* who are better able or more willing to assume the hazard.

Minimizing Risk through Management Practices. All classes of market risks can be reduced, frequently to a very considerable extent, through various management practices or devices. Preventive measures are employed to minimize possible losses from physical destruction or deterioration. Fire hazards are decreased by fireproof buildings and safeguards such as sprinkler systems, night watchmen, or fire inspections. Provision of proper storage conditions may forestall losses due to vermin, dirt, or extreme temperature changes.

Risks of theft can be minimized by the use of burglar alarm systems, night watchmen, safes for the protection of money or high-value merchandise, and other similar practices. Losses from shoplifting can be kept at a minimum by appropriate methods of displaying merchandise most likely to be pilfered; by training store employees to be observant in "policing" the selling area; and, in large institutions, by the use of store detectives.

Some personal risks, including accidents and, to a certain extent, sickness of employees, may be prevented by the adoption of safety devices, proper ventilation, and healthy working conditions. To guard against losses that may arise in the case of death or illness of key employees, competent substitutes can be trained for responsible positions.

For most firms, the only effective way to minimize credit risks is through efficient management in the granting of credit and the collection of accounts. This does not mean that all losses from bad debts will be eliminated. The most successful credit manager is not the one who has practically no losses but one who reduces losses from uncollectible accounts to a minimum, *without sacrificing sales volume.* Some losses must be expected in all businesses, and creditors should stand ready to bear their proportionate share. To keep this share of losses down to a minimum, sound control of credit operations is essential. Every concern, therefore, should set aside a reserve for bad debts, the amount of which is based largely upon past experience.

Both time and place risks that arise out of changes in market conditions can be controlled to a considerable extent through good management. Since most risks of market conditions result from changes in, or uncertainties regarding, supply and demand conditions, well-managed firms find it advisable to make careful qualitative and quantitative analyses of markets, and to gather and intelligently interpret market news from various sources. Only a study and analysis of information gathered from various sources enable one to ascertain the current status of the market and perhaps to forecast its future trend. With the multiplication and development of sources for reliable information and the perfection of rapid communication, knowledge of market conditions is increasing.

Proper and adequate control of a firm's stock on hand is one of the most significant earmarks of successful management. Only in this way can a buyer determine the quantity and quality of goods to be bought from time to time in order to prevent gluts and overstocks on the one hand and "outs" on the other. Careful planning of financial, merchandise, manufacturing, and selling requirements and a proper adjustment of these factors contribute much toward the reduction in risks of vendor or purchaser. Effective sales effort, including consistent and persistent advertising campaigns and intelligent personal salesmanship, may enable a firm to develop such favorable customer attitudes toward its products or service offerings that risks of changing market conditions are lessened.

Insurable Risks. While all classes of risks can be reduced substantially through good management, even the best managed firms are still confronted with various kinds of hazards that they are reluctant or unwilling to assume. Most business firms are quite willing to bear normal types of risks when they can afford to absorb possible losses without endangering their financial structure. On the other hand, most firms are not willing to assume risks when possible losses involve catastrophic consequences. Attempts are usually made to shift such risks to others if there is an opportunity to do so at reasonable cost. Some kinds of risks may be covered by insurance, which is a social or institutional device whereby the uncertain risks confronting

individuals are combined in a group and thus made more certain. Then, the certainty of a small, fixed insurance premium is substituted for the uncertain probability of a large loss.

Among the risks of physical destruction or deterioration, insurance protection is available and commonly carried for protection against fire, windstorm, hail, and damage to merchandise inventories, buildings, and equipment. Losses from theft by outsiders can be covered by insurance, and defalcation of employees may be insured against by having such persons bonded by surety companies. Personal risks involving key individuals are often minimized by insurance policies on their lives. Insurance is even available for certain types of protection against credit losses; it is, however, quite costly and provides only partial coverage, with the result that its use is relatively restricted.

Shifting the Risks of Market Conditions. Risks arising out of changes in market conditions are not insurable because losses cannot be anticipated with the accuracy needed for the calculation of insurance premiums; and, even if this could be done, the cost of such insurance would be a prohibitive expense for most enterprises. Consequently, various types of marketing agencies have sought other means of shifting at least part of such risks to others. Some of the ways in which this is commonly done are indicated in the following paragraphs.

Shifting Individual Risks to Society. Through various kinds of government regulation, some risks that would normally be borne by individual marketing agencies are assumed by society. A high degree of protection has been enjoyed by many companies when the government, under conditions of war or national emergency, has guaranteed minimum prices for certain products. Over a long period of war and non-war years, prices of certain basic agricultural products have been controlled or supported at given levels as a matter of public policy. This does not eliminate price risks arising out of changing market conditions, but does involve the shifting of a large part of the risk of individuals to the government and, consequently, to the whole of society.

Cooperative Activity. Risks incident to fluctuations in prices have frequently been reduced through the activity of trade associations. Although price fixing through such associations is contrary to law, it is probable that there still remain informal understandings among members of some associations with regard to prices that should prevail at a given time. Another example of risk-shifting activity is afforded by cooperative marketing organizations. When a large group of agricultural producers pool their commodities, the place and time risks arising out of sale in unfavorable markets are greatly diversified and minimized for each participant.

Production to Order. Some manufacturers and agriculturalists minimize their risks of market conditions by producing commodities that have been sold in advance. This is very common in the field of major industrial installations or the more expensive types of industrial equipment. It is also an ordinary practice in the field of men's and women's fashion apparel, especially in the upper price ranges. Most men's suits, for example, are sold to retailers from a sample line shown many months prior to delivery, and manufacturing is largely devoted to merchandise that has been sold in advance. Some farm products, as sweet corn, tomatoes, and pumpkins, are sold to canners even in advance of cultivation, and in some instances canners furnish the seeds or plants for this purpose. Production to order is characteristic of certain trades or industries but is not at all general throughout the economy. Where the practice exists, it is a matter of the seller shifting price risks to the buyer, who may or may not be in a better position to carry the risk, or who may in turn shift it to still another party.

Price Guaranties. Some vendors offer their customers guaranties against price declines. This involves shifting risks that may normally be carried by the buyer to the seller. The practice offers protection to purchasers who are hesitant in placing orders because of fear of a falling market, an unfavorable change in consumer preferences, or a modification of styles or model numbers.

Subcontracting. An illustration of shifting risks by contracts is afforded by the building industry. General contractors in the building trades submit bids for the construction of a building on the basis of their knowledge of the business and of other factors including the cost of materials, labor conditions, and so on. The successful contractor, if he is so inclined, may then proceed immediately to let subcontracts for necessary materials and for the construction of all or most of the different parts of the building. In this manner, the general and original contractor shifts most of his risk to those who are presumably experts in their fields, unless his estimates have been incorrect or some subcontractors fail to perform their function.

Hedging. One of the most important ways in which the risks of changing prices are shifted is through *hedging* by means of futures contracts. One party to such a contract may be an agricultural producer, a middleman, or a manufacturer, and the other party is most often a speculator—one who specializes in risk-bearing. Because hedging could hardly exist without the presence of numerous speculators who are willing to deal in futures contracts and because the role of the speculator is so often misunderstood or misconstrued in the popular press and in lay discussions, it is appropriate to consider the real nature of speculation and the machinery that has been developed for organized trading in futures contracts before any attempt is

made to present a detailed explanation of the process of shifting risks through hedging. The subject of hedging is covered in the following chapter.

Speculation: Its Meaning and Purpose

Purpose and Extent of Speculation. Every speculative transaction involves the assumption of risks incident to price changes in the commodity under consideration. Price changes may be due to seasonal differences in production and consumption or to changes in scarcity and abundance caused by irregular and inaccurate adjustments between supply and demand from year to year, season to season, and even from day to day. They may be due also to changes in financial, political, transportation, and other conditions.

Some of these risks may be assumed by men who specialize in this phase of marketing and who are commonly known as speculators or scalpers.[1] This aspect of speculation is ordinarily given undue prominence in every discussion of the subject, despite the fact that most speculative risks arising out of market price changes cannot be or are not normally transferred or shifted to speculators. These risks must, consequently, be borne by the various producers and middlemen engaged in merchandising.

Speculation is unavoidable so long as price changes take place. Every farmer or manufacturer who withholds his product from the market in expectation of a higher price, every merchant who buys unusually large quantities of goods for resale in anticipation of a rise in prices, engages in speculation. The same applies in a negative way to all individuals who delay the purchase of necessary merchandise and materials when a price decline is expected. Such speculative transactions may be either voluntary or forced. Merchants may find it necessary, for example, to purchase large stocks of merchandise when a transportation tie-up exists or becomes imminent or when the labor situation is extremely uncertain.

Speculation and Gambling. Many individuals are confused as to the exact meaning of the terms "speculation" and "gambling." In a great many cases it is indeed difficult to draw any line of distinction. Nevertheless, there is a common feeling that the one is legitimate and even desirable while the other practice is illegal or should be frowned upon and otherwise dis-

[1] The term "scalper" is used to describe a speculator who trades in futures contracts on the floor of an organized commodity exchange. He is generally content with profits that amount to only a small fraction of a cent per bushel of grain and usually turns over his commitments in a single trading session on the exchange. Then there is the "spreader" whose profit is made out of the ever-changing differences between options in one pit, between one grain or other product and another on the same exchange, or between one market and another as between Chicago and Minneapolis. Finally, there are varied types of open position traders (speculators) who take an outright "long" or "short" position either for a short time or for a major trend change and hold to that position.

couraged. Such a notion is, however, extremely vague and needs some clarification.

Legal Distinction. From a legal point of view, speculation must involve the presumption that delivery of the actual commodity traded in will be effected naturally and in accordance with the original intention of the contracting parties, merely as a result of the maturity of the contract. One implication of this definition is that speculation involves trading in an actual commodity, such as wheat, corn, or soybeans, whereas gambling involves risking *money* on the outcome of an event such as a horse race or the turning of a roulette wheel. A second implication is that the speculator must be prepared to receive delivery of the commodity if he is a buyer, or make delivery if he is a seller, whereas a gambler would have no intention of making or taking delivery of a horse, or football team, or roulette wheel, whichever is the basis for a bet. As a matter of actual practice, however, this second qualification for speculation has not been strictly observed in court decisions bearing upon the matter. It has been ruled in numerous instances that a financial settlement of a contract calling for future delivery of a commodity is in effect a legal delivery; actual physical transference of the real commodity is not a necessary prerequisite.

It is quite obvious that the legal distinction between speculation and gambling is impractical. In the first place, without overwhelming evidence, it would be a hopeless task to separate the gambler from the speculator on the basis merely of *intent* to deliver a commodity. In the second place, such a distinction does not seem to serve any special purpose, particularly when the law is so broadly interpreted that financial settlements of contracts are regarded as effective deliveries.

Possession of Knowledge. A second distinction involves the idea that the speculator is presumably a careful student of supply and demand conditions. He must have an opinion of the market in order to function efficiently, and such an opinion must be based on actual and reasonably anticipated conditions. A gambler, on the other hand, supposedly operates in a field concerning which he has little or no real knowledge. He merely guesses and is therefore often wrong. His operations, in following "tips" and "hunches," consequently tend to increase rather than diminish price fluctuations.

A valid objection to this point of distinction is that gamblers, particularly those of the "professional" type, may and often do possess as much, or more knowledge concerning their respective fields of activity as that possessed by so-called speculators. A gambler who consistently follows and bets on horse races, for example, may be intimately acquainted with the history and performance of all the horses and jockeys entered in a given race and may make his choice intelligently; yet his activities are frowned upon.

Assumption of Pre-existing Risk. While the foregoing distinctions bear some significance, they are more or less impracticable or otherwise questionable. Because of this, speculation and gambling may best be distinguished on the basis of the risks assumed. Accordingly, speculation is said to consist of the assumption of risks *which already exist and are inevitable,* while in gambling the risks assumed are said to be *created for the purpose.* In gambling, the risk assumed is artificial, like betting on a horse or a hand of cards.

Regardless of whether or not a wager on the outcome of a football game is effected, the game will be played and its purposes of providing entertainment, fostering sportsmanship, and building physique will be accomplished. If gambling is permitted on such contests, unnecessary hazards are created and there is also a likelihood that many persons who can least afford it will engage in the practice. At any rate, the public gains no benefit whatever from gambling but is subjected to considerable potential harm. Speculation, on the other hand, involves the assumption of kinds of risks that must be borne by some one. When such risks are assumed by a specialized group of individuals, the activities of this group operate to diminish the business risks of others, who transfer their risks to the specialists. Thus, according to this most realistic view, speculation, whether engaged in by farmers, manufacturers, or middlemen or engaged in by specialists known as speculators, involves the performance of a universal and inescapable marketing function—that of risk-bearing.

Speculation and Futures Trading

Contracts calling for the future delivery of goods are common in all lines of business. The term "futures trading" is, however, ordinarily applied only to a special type of contract, bought and sold according to the rules of organized commodity exchanges. It is in such contracts that professional speculators concentrate their trading efforts, and it is the existence of such contracts that makes it possible for some businessmen to shift certain risks to speculators.

Characteristics of Futures Trading. In the case of certain staple commodities the prices of which fluctuate with great frequency, futures trading is common and very important. A futures contract may be defined briefly as *an agreement between two parties—one who agrees to sell and deliver and one who agrees to buy and receive* (1) *a certain kind and quantity of a commodity,* (2) *at some specified future time,* (3) *at a specified price, and* (4) *according to the conditions of trading prescribed by an organized commodity exchange or conditions generally understood in the trade.* Payment and delivery are postponed to a future time, for the goods may not

even be in existence at the time of the contract, as is the case of many grain contracts made before the commodity has actually been harvested.

A futures contract is an *agreement* to buy or to sell and not a consummated purchase or sale. Such contracts, regardless of the specific commodity involved, generally have certain prescribed characteristics that have been established for the purpose of simplifying the trading activity. First, all contracts involve a standard quantity unit of the commodity or some multiple thereof. Thus, in wheat futures, trading is in terms of "round lots" of 5,000 bushels. Similarly defined standard units are recognized for other commodities. Second, trading is ordinarily confined to a single so-called "contract" grade or to a few such grades specified for this purpose. The assumption is that prices of grades other than those recognized for trading purposes will fluctuate in the same manner as contract grades. It is, accordingly, not necessary to establish machinery for trading in all recognized grades of a commodity. Third, delivery of the commodity must be made during a specified month. Futures trading does not involve specific delivery dates; rather, the seller has the option as to the day of the specified month that he will make delivery. Fourth, the seller has the option of delivering grades higher or lower than the contract grade, at a specified premium or discount from the contract grade as the case may be. Fifth, the commodity to be delivered on the contract must be weighed and graded by licensed inspectors. Finally, delivery must be made from approved warehouses. These characteristics constitute elements of standardization in exchange, which are well understood by those engaged in futures trading, and because of their existence and widespread acceptance, such contracts may be effected speedily and without delay.

Even though considerable attention is devoted to the terms of *delivery* in the foregoing discussion, such contracts seldom involve actual physical delivery of the commodity from seller to buyer. They may be eliminated or canceled by offset, requiring only a settlement of price differences through "clearing houses" operated in connection with organized commodity exchanges. For example, a trader may feel that the present price of wheat for delivery during a specified month is too low. He would take a "long" position, i.e., buy futures contracts upon the assumption that the price will later rise and thereby afford him a profit. The amount so purchased would be entered upon his account in the clearing house. Later the price may actually rise somewhat and he might then take a "short" position, i.e., sell a futures contract involving the delivery of grain that he does not actually own. This would be similarly entered upon his account in the clearing house, and if identical quantities are involved, would cancel his obligation to make or accept delivery of the physical commodity. Settlement may be made merely through the clearing house by receipt (or payment) of the price difference involved. It is only in instances where purchases of futures

are not offset by sales made prior to the end of the delivery month that delivery of the actual commodity must be made.

Organized Trading in Futures. As has been implied in the foregoing discussion, dealing in futures is almost always connected with established commodity exchanges and boards of trade,[2] largely because futures trading to be most effective must be handled on a large scale. Facilities for organized trading are used by two types of parties: *hedgers* who wish to transfer a time risk to someone else, and *speculators* who wish to earn a profit by assuming the risks that are incident to fluctuating prices. Ordinarily the hedger is not interested in making or in accepting delivery of a futures contract. He merely wants to hold certain contract rights as protection against unfavorable changes in price. An ever available opportunity to buy or sell futures in amounts to counterbalance his spot-commodity risks is essential to real protection from unforeseen major price movements.

Trading on the commodity exchanges is usually made up of two classes of transactions, "spot" or "cash," and futures. Spot or cash transactions involve the actual commodity, available for immediate delivery at the place where it is offered for sale; this is in contrast with futures, which involve delivery of a specified grade of a commodity, which may or may not be in existence at time of contract, during some specified future month. Cash sales or purchases are mostly based on samples of the commodity that are inspected by prospective purchasers at the exchange; futures contracts, on the other hand, are based upon contract grades and the trade's understanding of the specifications involved in such grades. Thus the commodity exchange provides both a market for the current exchange of actual commodities as well as facilities for organized trading in futures contracts.

The nature of futures trading makes the careful grading of commodities a prime essential. As previously indicated, ordinarily one of the grades of a given commodity is designated by the exchange as the basis or contract grade, as for example the No. 2 grades in all grains and Middling for cotton. In selecting a basis grade it is aimed to obtain as nearly a uniform quality as possible and a supply of the grade that is plentiful to make corners impossible under normal circumstances. Other specified grades are, however, deliverable at a premium on, or a discount off, the basis or contract grade, such differences also being established under the rules of the exchange.

Commodities in Futures Trading. The products subject to futures trading on organized exchanges are not confined to the grains as is commonly supposed by the layman. Futures trading facilities are available on organized commodity exchanges for barley, burlap, butter, cocoa beans, coffee, corn,

[2] For a detailed discussion of the activities of various specific commodity exchanges, see Chapter 28.

cotton, cottonseed meal, cottonseed oil, eggs, flaxseed, hides, lard, certain metals (lead, copper, tin, zinc, and platinum), millfeeds, oats, onions, potatoes, crude rubber, rye, grain sorghums, soybeans, soybean meal, soybean oil, sugar, tallow, wheat, grease wool, and wool tops.

To qualify for futures trading on the exchanges, a commodity must possess certain prerequisites. One is that the product must be so standardized that the various units are conveniently interchangeable. Second, it must have durability or a minimum degree of perishability to permit storage for future delivery without appreciable deterioration. Third, there must be an adequate amount of the actual commodity available from year to year. The purpose of this requirement is to maintain a proper connection between the cash or spot market and the futures market, although futures trading need not necessarily be accompanied by extensive cash trading in the same center. Fourth, to insure continuous trading—necessary to an efficient futures market and to cover the cost of maintaining the required facilities—a large volume of trading is highly desirable. Fifth, the supply of the commodity must not be controlled by a few large interests but must have large enough so-called *natural* price variations to encourage hedging operations and to attract speculators.

Benefits of Organized Speculation. If all of the goods which are manufactured from the nation's important basic commodities were consumed with great regularity, *and* if 1/52nd part of the annual requirements for each such commodity were produced during each week of the year and also marketed during the same week, *and* if the supply of each such commodity were produced in the areas where needed for further processing and consumption purposes, *and* if the quality and the price of all such commodities always remained the same, there would be little or no need for organized facilities for futures trading. Similarly, there would be no economic justification for the professional speculator. In the absence of such conditions, organized speculation may be justified both from an individual and social point of view for the following reasons:

Tends to Stabilize Prices. In the first place, if carried on by competent persons, speculation tends to stabilize prices and prevent undue fluctuations. When the price of a commodity commences to decline below what is regarded as warranted by actual and anticipated conditions of supply and demand, speculators begin to purchase large quantities of the product. Similarly, when the price of a given product rises beyond what may be regarded as warranted, speculators begin to sell. In this manner, the tendency is for the speculator's activities to check both an undue rise and decline in prices, thereby steadying or stabilizing prices so long as supply and demand factors are anticipated with some degree of accuracy.

Wide and Continuous Market. Second, speculation makes possible a wide and continuous market. Regardless of the immediate demand of purchasers, sellers can dispose of their products whenever they desire, since some speculators are always willing to assume risks of ownership at the current market price. If there were no speculators, the tendency would be for prices to drop very low immediately after harvest when growers generally sell their crops. Furthermore, so-called "legitimate" buyers, including merchants, millers, and other manufacturers, would not wish to accumulate large inventories of raw materials in advance of actual need except at much wider margins than now exist, for the transactions would involve too great uncertainty. Through specialization and hedging, speculators are able to assume such risks on smaller margins than would otherwise be demanded by other purchasers. This inures to the benefit of all concerned, including the consuming public. Furthermore, as speculation involves forecasting changes in value, and buying and selling to take advantage of them, it makes for an orderly adjustment of the market to the probable.

Equalizes Markets. Third, speculation tends to keep "in line" the various markets, both national and international, through what is known as spreading or arbitraging. This involves buying in the markets where prices are lower than warranted and selling at points where prices are higher than warranted. Such activities tend to wipe out important discrepancies by increasing the demand in the former markets and raising the supply in the latter.

Facilitates Hedging. Finally, speculation makes it possible for the merchant or manufacturer to shift his risk more readily, since hedging could not practically function in the absence of speculation. Theoretically, all hedging transactions may be carried on by bona fide merchants and manufacturers. Thus, a textile mill may protect its purchases of raw cotton by selling a given quantity for future delivery to another mill which desires to purchase the same amount of cotton for delivery during the same future month. The second mill thus protects its contract sales of cotton goods until the raw cotton of the desired quality is actually bought. Normally and practically such a coincidence with regard to quantity and time of the contract and delivery is well-nigh impossible. Hence hedging practically requires the presence in the futures market of speculators to take the other end of the hedge. To hedge satisfactorily there must always be available a continuous futures market with such a volume of trading as to make it possible for hedges to be promptly executed without affecting the price. A wide and continuous market also facilitates the financing of stored goods and their transfer in ownership. Thus all the benefits of hedging that are discussed in the following chapter can be best attained through the operations of speculators.

Objections to Speculation. The economic function of speculation and the general benefits that accrue to society as a result of the existence of organized facilities for speculation are not understood by the public at large. Consequently, many objections and criticisms have been raised from time to time. Such objections have been directed, as a general rule, only at organized speculation such as is carried on in connection with the commodity exchanges and boards of trade. Unorganized speculation is so pervasive and so common to all of our activities that it is only rarely considered when the term is referred to in any condemnatory fashion.

One commonly voiced objection to organized speculation is that products change hands too many times, thereby necessitating a duplication in effort and much useless handling. This objection is based altogether on misunderstanding. No actual transfers of property are involved in the vast majority of speculative trades. Many transactions are offset by other transactions and canceled through machinery provided for the purpose, usually by an organized body of traders. In many instances transfers of title may not take place, and when they do they may only involve delivery of a warehouse receipt and no handling whatever of the goods themselves except when they are actually needed for shipment or manufacture and use.

A second objection is that speculators take excessive profits which are made possible through large-scale speculative buying and selling that influence prices to the advantage of speculators. This criticism is also largely based on misconception. Unless it is abused, speculation has only a temporary effect upon prices, for prices are determined by actual supply and demand factors which speculators attempt to ascertain and follow. In the case of agricultural commodities, the factors affecting the supply are size of the current year's harvest, amount of carry-over from the preceding harvest year, and estimates of the size of the crop during the next harvest season. On the demand side of the picture, there exist the requirements of millers, maltsters, cereal and feed manufacturers, stock feeders, processors, and the government's activities in the market in connection with purchases for export to foreign countries, stock-piling, or for price-supporting purposes. In addition to these factors, price is somewhat influenced by competition that exists between certain commodities. If the price of one grain gets out of line, increased demand for other grains tends to bring it down. Cottonseed meal and soybean meals, for example, compete with each other; similarly, barley, instead of corn, can be fed to livestock.

Even in the absence of speculators prices would rise and fall in obedience to changes in these conditions of supply and demand. In fact, the tendency would be, under such circumstances, for prices to undergo wider fluctuations with correspondingly heavier gains and losses to the individuals who chose to hold the product in anticipation of a rise in prices or to refrain from purchasing their requirements when a decline was

expected to take place. Under our present system, fluctuations in prices are narrower and the total profit or loss is divided among a number of speculators, each bearing a share of the risk. They neither raise nor lower prices but rather follow what they regard as the natural movement of prices as warranted by existing economic conditions.

Third, it is often alleged that speculation has given rise to certain pernicious practices and abuses. One of these is that speculation has encouraged an undesirable amount of trading by ignorant or inexperienced persons. On every exchange there is a certain amount of trading by what are known in trade language as amateur speculators. These comprise farmers, doctors, lawyers, merchants, and others, who send in their orders for speculative trades to the brokers or commission houses. All of them have their market opinions and are willing to support them by investing their capital. Because of their inexperience and lack of real knowledge concerning probable market conditions, they usually sustain heavy losses and may in addition exercise an unfortunate effect on the market by forcing prices away from the trend they would have taken had the market been properly forecast. Practically every occupation is represented by holders of open commitments in wheat and corn, nearly 600 vocations having been enumerated in one study. To be sure, professional speculators frequently profit from the presence in the market of casual, uninformed, or incompetent outsiders, who generally perform no definite economic service, but it is very difficult to devise any system that will entirely prevent such "lambs" from being fleeced or from going voluntarily to the slaughter.

Trading with insufficient capital is another abuse of speculation. Considerable loss and financial embarrassment may be caused as a result of default by a party to a futures contract. This danger is practically eliminated on the organized commodity exchanges by requiring traders to furnish adequate margins to cover all differences in prices that may reasonably obtain within the life of the contracts or to provide security in some other way.

Again, speculators sometimes manipulate prices through the spreading and circulation of false rumors and misinformation, through what are known as "corners" and "squeezes," or by buying or selling in a concentrated manner in order to produce the desired effect on prices. In this manner the operations are artificially directed into a channel that is opposite to the normal trend of the market so that the manipulator may take advantage of the situation as soon as normal forces begin to operate. A corner may be defined "as an acute attack of monopoly." When a product is cornered, a large portion of the available supply is controlled by one individual or a small group of persons who, by refusing to sell, create an artificial scarcity with a resulting rise in price. While cornering is prohibited by law and has been rendered practically impossible by the exchanges

themselves, "baby" corners known as "squeezes" are not uncommon. To minimize their effect and for other reasons, the Commodity Exchange Commission (composed of the Secretary of Agriculture, the Attorney General, and the Secretary of Commerce) promulgated in July, 1938, a limit to speculative trading in grain futures. Under this a trader is limited in his net long or short position to a total of 2,000,000 bushels of wheat, and to one-half that amount for any one delivery month.

Finally, there is the trading on price movements, which means "going with the market." This type of trading is done by some professionals, who buy when prices are advancing and close out their holdings when the trend has been reversed. Unlike true speculation, a large amount of this type of trading tends to unsettle the market and may widen rather than narrow price swings. As a practical matter, it is impossible to distinguish "movement" trading from the activities of scalpers, whose activity is a stabilizing one, and from the activities of other true speculators who are in the market for a long pull. Even though movement trading is perhaps antisocial, and true speculation is economic and desirable, it would be exceedingly difficult to set up controls that would eliminate the one type of trading without curbing the favorable aspects of the other.

Facilities for the Promotion of Speculation. Outside of the field of manufactured goods, in which the major part of the risks caused by price changes is borne by the merchants and manufacturers themselves, speculation has been greatly facilitated: first, by the existence of organized markets; second, through grading and standardization; third, through special financial arrangements made available for the purpose; and fourth, through the gathering and dissemination of useful market information.

Exchanges have done much to eliminate or reduce the evils of speculation and to provide the machinery requisite to the successful handling of hedges and to the settlement of differences or matching of contracts. Furthermore, they provide the continuous and wide market which is essential to the best form of hedging and speculation. Without standardization or grading, speculation would be virtually impossible. Futures contracts assume the ability to deliver a specific quality of product or to pay or collect a premium, as the case may be, for any difference in the quality delivered from that specified in the agreement. Consequently, speculation may be encouraged by the development and adoption of well-recognized standards for various commodities. Correct and adequate market information as a basis for opinions of the trend of price is equally essential to the best type of speculation. Only on the basis of such data can the market be properly forecast and risks reduced to a minimum. Finally, dealing on margins with adequate protective provisions established through legislation or through the various organized markets, makes it possible for compe-

tent speculators to exert a wholesome and beneficial influence by the use of relatively little capital.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) speculation
   b) gambling
   c) time risk
   d) place risk
   e) contract grade
   f) futures trading
   g) "long"
   h) "short"
   i) spot or cash grain
   j) hedger
   k) "corner"
   l) "squeeze"
   m) "going with the market"
   n) scalper

2. In what way is the speculator similar to the insurance company? In what way are the operations of speculators unlike those of insurance companies?
3. Explain how two general methods of minimizing market risks may be applied to each of five different classes of market risks.
4. What class of market risk presents the greatest problems to businessmen who must assume risk? Why?
5. Does society benefit from organized speculation? Explain.
6. Explain several different criteria that have been used by various persons in attempts to distinguish speculation from gambling. Which criterion is most realistic or meaningful? Why?
7. Can an organized market function *effectively* without speculation? Explain. Can it function *at all* without speculation?
8. Is an agent middleman subject to the same market risks as a merchant middleman? Explain the difference, if such exists.
9. A legislator, in presenting a bill to limit speculation on grain exchanges, gave the following reasons for his action: (*a*) duplication of effort and expense; (*b*) too many profits; (*c*) increased fluctuation in prices; (*d*) provides a legalized house of gambling. Evaluate each of these arguments.
10. A mail order house insures its buildings and equipment against fire and its cash against theft, but it does not insure its outgoing packages while they are in transit. How do you account for such a policy?
11. Futures trading is very important in agricultural products and in certain basic metals. How do you account for the fact that there is no futures trading in bituminous coal, nor does there seem to be any demand for it although it is one of our most important raw materials? Would futures trading in bituminous coal be possible if there were a demand for it? Explain.
12. You are a candy manufacturer located in New York City and generally buy your sugar from a Cuban refinery. With the indication of rising commodity prices, what can you do to protect yourself against any loss in your sugar-purchasing program?

13. A group of wholesalers dealing in fresh fruits and vegetables felt that it would be desirable to establish a futures market for oranges, grapefruit, lemons, and apples. Their enthusiasm for such a venture stemmed from a recent visit which they had made to the Chicago Board of Trade, where all the advantages of trading in futures were explained to them. If you were called in as a consultant, what would be your advice and on what would you base it?

14. Company A is a manufacturing concern that makes and sells several items of industrial goods to other manufacturers. The bulk of its sales volume is accounted for by six large purchasers, and sales are made to these customers on a credit basis. Annual sales of the Company amount to approximately \$4,500,000. Company B is a large department store in which *credit* sales amount to approximately \$15,000,000 per annum. Company A carries credit insurance whereas Company B does not. Assuming that both companies are aware of the existence of this type of insurance, how can you account for this situation?

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HEDGING AND ORGANIZED EXCHANGES

Of all the market risks briefly discussed in the preceding chapter, by far the most important, most hazardous, and yet most complicated in many segments of the economy is the market risk incident to changing prices of certain basic commodities. The manner in which such risk is shifted and minimized through hedging, and the marketing institution through which it is accomplished are discussed in this chapter.

Nature and Purpose of Hedging. Risks arising out of changing prices, in obedience to constant changes in supply and demand conditions, affect those businessmen who own commodities while in storage, while they are being processed, or when in the form of inventories of finished goods until they are sold. The market position of such businessmen is known as "long," and to them an adverse price change is a decline. The risk of a declining price on a large warehouse full of baled cotton or on a terminal elevator full of wheat is much too large for a single owner of the goods to assume without courting financial ruin. Market price risks also affect those businessmen who anticipate buying a given commodity at a later date in order to make delivery on a previous sale of such commodity or the finished product into which it enters. The market position of these businessmen is known as "short," and an adverse price change to them is a rise, not a decline. Whether in a long or short position in the market at any given time, all commodity handlers such as managers of grain elevators, flour millers, food processors, distillers, feed manufacturers, cotton merchants, tire manufacturers, and many others are deeply concerned with the problem of price change and are anxious to avoid or at least to minimize such risk whenever it is possible to do so. Hedging is the device utilized for the purpose, and the organized commodity exchange is the mechanism or marketing institution through which the device is made effective.

Hedging involves a shifting of an existing risk incurred in the cash or spot market by setting up another risk in the futures market that is the counterpart of the first risk. The practice may be more specifically defined as *the process of entering simultaneously into two contracts of an opposite, though corresponding, nature: one in the spot or cash market and the other in the futures market.* The contracts are opposite in that one involves a purchase and the other a sale, but they correspond in regard to the amount of merchandise covered.

In order to understand the purpose of hedging, it is necessary to distinguish between "trade profit" and "speculative profit." Trade profit arises out of the performance of marketing or manufacturing functions, whether it be trading in the commodity, storing it for future need, or milling, processing, or manufacturing other goods from the commodity. Speculative profit, on the other hand, accrues from favorable price changes, and speculative losses are suffered as a result of price changes which adversely affect a businessman's market position.

Hedging is a process of shifting risk and thereby it affords protection for the trade profit anticipated by a handler of a commodity. It is a means of protection against speculative losses arising out of adverse price fluctuations, but it involves the necessity of foregoing the opportunity for securing a speculative profit if price changes should prove favorable to the hedger.

For example, a flour miller purchases a large quantity of wheat expecting to manufacture it into flour. At the same time that he makes the actual purchase of this commodity, he sells through his brokerage house futures contracts covering as nearly as possible the same quantity of wheat that he purchased for use. His position thus becomes fairly safe, regardless of whether the price of wheat goes up or down. If the price of wheat declines substantially before he sells the flour, he will have to sell the flour at a lower price than he anticipated; he will, however, make an offsetting profit on the futures contract because he can buy it out for a lower figure than it was originally sold for. If the price of wheat rises, he will be able to sell the flour at a higher price than anticipated, and make a speculative profit as well as his normal trade profit; in this case, however, he will experience an offsetting loss because he will have to buy out the futures contract at a price higher than the futures sale.

To secure maximum protection through hedging, the existence of a nearly parallel movement in spot and futures prices must be assumed. A so-called "normal futures market" is one in which the futures price for a commodity is at a premium over the current cash or spot price by the amount of the "carrying charge" on the product. The carrying charge ordinarily includes the items of storage, interest, insurance, and the physical handling of the commodity incident to its storage.

For example, assume that the price of spot wheat of contract grade is $2.40 per bushel on December 1 and that the carrying charge for wheat is two cents per bushel per month. In a normal futures market, the price of wheat for May delivery would be $2.52 per bushel, since it is six months until the end of the delivery month for May futures. If the price of spot wheat should rise to $2.45 per bushel on December 2, the normal situation would be that the price of May futures would rise to $2.57; similarly, if the price of the spot commodity should decline to $2.30, the price of the futures would go to $2.42. *Complete protection against losses from price changes can be realized only under circumstances where the spread between the spot and futures prices remains the same as carrying charges during the life of the hedge.*

Hedging in Practice

In actual practice, hedging is a highly technical and complex undertaking. It can be understood thoroughly only when studied in very great detail.[1] It is nevertheless possible to illustrate the practice of hedging by several cases which bring out the principle involved and reveal the effects of hedging operations.

Hedging by Country Elevators. The practice of hedging on the part of country elevators is by no means universal. Grain may be sold outright as soon as it is bought; hence the need for hedging is shifted to the new purchaser. A coincidence between purchases and sales of cash grain may be brought about by other merchandisers, so that the cash grain purchase or sale is offset by an opposite transaction in cash grain instead of in futures. Again, elevator managers may hedge only a part of their purchases and speculate on the remainder. They may use the hedging market only when their commitments are especially heavy and let price fluctuations on small stocks take care of themselves.

The major function of the country elevators is to concentrate grain at the local market for expeditious and economical shipment to central markets. Some time necessarily elapses between the purchase of the grain by

[1] In order to avoid confusion on the part of those who are beginning the study of marketing, many of the refinements of hedging have been omitted. These include the hedging of so-called "stored" grain by the country elevator; the hedging of grain and cotton for export; the practice of "spreading" or arbitraging involving simultaneous transactions in more than one market in order to improve the relative position which the future, used as a hedge, bears to the cash transaction; "on call" transactions frequently used in the cotton trade; and a number of other interesting but highly technical aspects of the subject. Additional illustrations of hedging may be found in *Hedging: An Insurance Medium in Marketing Agricultural Commodities* (Chicago: Chicago Board of Trade); *Marketing Grain Through a Grain Exchange* (Urbana, Ill.: Vocational Agricultural Service of the University of Illinois); and *How to Hedge Commodities* (New York: Merrill Lynch, Pierce, Fenner & Beane).

the local elevator and its sale at the central market. Delays occur in securing cars, adequate quantities may not be available for immediate shipment, or the elevator manager may desire to hold the grain for other reasons. Whatever the cause, the element of time is significant, for it involves danger of loss.

Let us assume that the dealer or country elevator buys on September 1 about 10,000 bushels of red winter wheat at $2.16, *with the expectation of selling it in the central or terminal market at $2.30,* the current market quotation for the grade of wheat under consideration. The margin of 14 cents per bushel provides for the cost of transporting the grain to the central market and covers the operating expenses of the elevator, leaving a net profit of 3 cents per bushel for the elevator's merchandising operations. Inasmuch as this grain cannot reach the central market in less than about five days, it is probable that different prices will prevail at the time it is sold there. If fluctuations have been upward and the price has gone up to $2.35, a speculative gain of 5 cents per bushel will be realized. If the price has declined to $2.25, there is, in the absence of hedging, a loss of 5 cents per bushel. It is obvious that few dealers can afford the losses incident to unfavorable changes in prices, particularly when large physical quantities of grain are involved.

In order to protect himself by *hedging,* the dealer sells through his representative on the central market exchange on September 1, a *futures* contract for the same amount of wheat, for delivery in December—the next important wheat futures month. For adequate protection by hedging, the sale of a futures contract is made almost simultaneously with the purchase of the cash grain.[2] The futures contract is made at the prevailing price for December futures, $2.38. The difference between the cash and the futures price, amounting to 8 cents, represents the charges incident to the carrying of the grain over to the month in which delivery is presumably to be made. The spread, which in the case of most grains approximates 2 cents per bushel per month, includes the futures month in a normal market since it is the seller's option as to just when during the month delivery will be made.

When the cash grain finally reaches its destination on September 6, it is sold at the market price prevailing at the time which, we shall assume, is $2.24. Thus a loss on the actual handling of the grain of 6 cents per bushel is incurred, the full brunt of which would have been borne by the elevator if he had not hedged the transaction by an offsetting futures contract. Because of the hedging transaction, however, the elevator in-

[2] Sometimes the operator may wait for a more favorable price before placing his hedge, and the same may be true of withdrawing a hedge instead of allowing the time of the purchase or sale of a future to be determined automatically by the cash transactions.

structs the broker simultaneously to buy a similar contract for December delivery that will cancel out his obligation to deliver on the futures sale made on September 1. So long as the market is normal, futures prices move sympathetically with cash prices and the futures contract can now be bought at $2.32, which involves a spread of 8 cents between cash and futures prices. Thus, as indicated in Case I, the loss on the cash or spot grain is offset by a gain of a similar amount on the futures transactions, thereby affording protection to the operator against risk of speculative loss because of adverse price changes.

CASE I HEDGING ON A DECLINING MARKET

Date	Cash Grain		Date	Futures	
Sept 1	Bought 10,000 bu #2 red to be sold at	$2 30	Sept 1	Sold 10,000 bu "Dec" at	$2 38
Sept 6	Sold 10,000 bu #2 red at	2 24	Sept 6	Bought 10,000 bu "Dec" at	2 32
	Loss on spot market	$0 06		Profit on futures market	$0 06

Detailed Presentation of Case I

Date	Cash Grain		Price per Bu	Date	Futures	Price per Bu	Cash-Futures Spread in Cents
Sept 1	Bought #2 red winter on track country		$2 16	Sept 1	Sold Chicago December futures	$2 38	22¢
	Chicago equivalent		2 30			2 38	8¢
	Freight to Chicago	7¢					
	Handling costs*	4¢					
	Profit	3¢					
	Margin	14¢					
Sept 6	Sold #2 red winter Chicago		2 24	Sept 6	Bought Chicago December futures	2 32	8¢
	Country equivalent		2 10			2 32	22¢
	Net loss per bushel		$0 06		Net gain per bushel	$0 06	

* Includes the brokerage fees for hedging, amounting to ⅜¢ per bushel for the completed hedge

CASE II HEDGING ON A RISING MARKET

Date	Cash Grain		Date	Futures	
Sept 1	Bought 10,000 bu #2 red to be sold at	$2 30	Sept 1	Sold 10,000 bu "Dec" at	$2 38
Sept 6	Sold 10,000 bu #2 red at	2 32	Sept 6	Bought 10,000 bu "Dec" at	2 40
	Gain on spot market	$0 02		Loss on futures market	$0 02

If the spot price on September 6 had risen to $2.32, as shown in Case II, the gain in the cash market would have been offset by a similar loss in the futures market. It follows, therefore, that so long as the parallel movement in spot and futures prices prevails, the dealer who has hedged the purchase of spot grain by the sale of a future, if grain declines in price,

will have a loss arising from the sale of grain on a lower market which will be offset by a gain arising from the purchase of a future at a correspondingly lower price when he closes out the hedge. On the other hand, if grain advances he will have a gain arising from the sale of spot grain on a higher grain market, which will be offset by a loss from the purchase of a future at a correspondingly higher price when he closes out his hedge. The hedge consequently tends to eliminate both losses and gains that are caused by changes in the general level of spot grain prices. *This removal of speculative hazards necessarily leaves the gains and losses arising out of merchandising or manufacturing operations substantially untouched.*

Hedging by Terminal Elevators. Hedging operations are consistently used by terminal elevator companies in connection with the storage of grain. These merchandisers buy grain as it arrives from the various country points during the autumn and hold it over until it is wanted for milling, exporting, or other purposes. Inasmuch as they handle the grain in exceedingly large quantities—many individual elevators have a storage capacity of more than a million bushels and several have a capacity of 10 or more million bushels each—even minor changes in price may involve a serious total loss. Consequently, they generally protect themselves through hedging in a manner similar to that indicated above. The common practice is to hedge the daily balance at the market opening on the following day.

Hedging by Millers. Hedging in grain is used widely by millers, maltsters, and manufacturers of cereal products. Flour millers, for example, frequently find it advisable to secure such protection of their profit arising from the margin between the prices of flour and wheat. So long as the purchases of grain and sales of flour are effected simultaneously, hedging is not necessary. A miller may buy his grain for storage and immediately sell his flour for future delivery, or he may first sell his flour for future delivery on the basis of existing market prices of the raw commodity and then go into the market at once and buy the necessary amount of grain for future delivery to him. In either case he is assured of the profit arising out of his manufacturing operations, which is his principal or only source of revenue, regardless of subsequent fluctuations in grain prices. In the first instance, he is protected against a fall in the price of flour; in the second, against a rise in the price of grain. But if the miller buys wheat in October for conversion into flour which cannot be sold simultaneously for future delivery, there is considerable risk, for if the grain price declines in the meantime, he will not be able to sell his flour at remunerative prices. Similarly, if the miller sells flour for future delivery without having the wheat in his possession at the time, there is a possibility that he may have to pay a higher price for the grain than he had anticipated. Hedging offers a practical solution in both cases.

Hedging Grain Stock. Let us assume, as shown in Case III, that on November 1 a miller buys 15,000 bushels of a desirable grade of hard winter wheat at the prevailing market price of $2.24 without having sold the flour to be made from it and is thus in what may be termed a "long" position in the market. It is not uncommon for flour millers to accumulate wheat in storage, since this offers them an opportunity of buying virgin or unmixed grain of desirable quality during the autumn as it comes from the country districts. In the case in question, the miller does not expect to manufacture this particular quantity of grain before January. A hedge is effected by making a sale of a corresponding quantity of wheat for May delivery. It is assumed that a normal market prevails—hence, the futures price on November 1 is $2.38, which represents a spread of 14 cents over the current spot price on the assumption that carrying charges amount to 2 cents per bushel per month.

The miller finally converts the grain into flour and sells it on February 3. Assume, however, that the price of wheat has declined and was $2.00 in the spot market on this date. The spot grain was purchased for $2.24 on November 1 and sold on February 3 in the form of flour priced to yield a normal trade profit at a cost of $2.00 per bushel of raw material. If the miller had not hedged, he would have suffered a speculative loss of 24 cents per bushel plus the 6 cents carrying charges for three months, or a total loss of 30 cents per bushel. On February 3, however, he was able to buy *in* a futures contract at a profit which offset the loss in the spot market. By hedging, a speculative loss of $4,500 was avoided on this particular quantity of wheat (15,000 bushels times 30 cents per bushel).

CASE III. MILLER'S HEDGE ON A FALLING MARKET

Date	Spot Grain		Date	Futures	
Nov. 1	Bought 15,000 bu. at	$2.24	Nov. 1	Sold 15,000 bu. "May" at	$2.38
Feb. 3	Sold 15,000 bu. at*	2.00	Feb. 3	Bought 15,000 "May" at	2.08
	Gross loss on Spot	$0.24			
	Plus. Carrying charge for 3 months at 2¢ per bushel per month	$0.06			
	Net loss	$0.30		Net profit	$0.30

* The equivalent in flour priced on the basis of wheat costing $2.00 per bushel.

In a rising market, hedging of a stock of grain requires that the miller forego the opportunity of making a speculative profit. If the price of wheat had risen substantially between November and February, the price of flour would also have risen, permitting such a profit opportunity in the spot market. This would have been offset by a corresponding loss in the futures market.

In this illustration it has been assumed that the prices of flour and wheat fluctuate together, inasmuch as the raw commodity constitutes by far the major item of cost of the finished product, and the manufacturing process is not of long duration. Thus, changes in prices of flour can be hedged against by the purchase or sale of grain for future delivery on the basis of existing prices.

Hedging Against a Forward Sale of Flour. Some millers frequently contract with large baking companies and others to deliver flour at some future time at an agreed price. At the time that such a contract for the delivery of flour (an actual commodity) is made, the miller may not have the wheat in his possession and he may not wish to purchase the actual grain until the approximate time to make delivery on the flour contract. He may not have the necessary funds or storage facilities or may be unable to find at that time just the quality of grain he desires to purchase for the quality of flour to be milled. In such an instance, the miller opens a hedge by purchasing a futures contract; and when he finally secures the cash grain, he closes out the hedge by a sale of a futures contract for the corresponding quantity.

CASE IV MILLER'S HEDGE AGAINST A SALE OF FLOUR

Date	Spot Grain		Date	Futures	
Nov. 1	Sold flour calling for 10,000 bu. of wheat on basis of current price of	$2.24	Nov. 1	Bought 10,000 bu. "May" at	$2.38
Apr. 5	Bought 10,000 bu. at	2.41	Apr. 5	Sold 10,000 bu. "May"	2.45
	Gross loss	$0.17			
	Less Carrying charge (5 mos.)	0.10			
	Net loss	$0.07		Net gain	$0.07

This method of hedging is illustrated in Case IV. It is assumed that on November 1 the miller negotiates a contract calling for the delivery of flour late in April. It is estimated that 10,000 bushels of wheat will be required to fill the contract. The miller does not have storage space available and for other reasons does not wish to purchase the wheat until early in April. The price of the required grade of wheat is, on November 1, $2.24 per bushel, and the miller knows that it will cost approximately 10 cents to carry wheat over the five-month period until he actually needs to make a purchase of grain to fill the flour contract. He sets the price of flour on the basis of wheat costing approximately $2.34 at time of milling and delivery of flour ($2.24 plus 10 cents carrying charges). In setting this price on flour, he makes allowance for his manufacturing costs and normal trade profit. If the price of wheat should rise before he purchases the grain, his raw material cost would be more than anticipated and he would suffer

TABLE 22

Basic Facts About Important Commodity Futures

Commodity	Standard Contract Size	Minimum Price Variation		Most Actively Traded Futures Months	Crop Year	Normal Seasonal Price Pattern		Important Exchanges Where Futures Are Traded
		Per Unit	Per Standard Contract			High	Low	
Butter	20,000 lb.	.05 of 1¢ per lb.	$10.00	Apr., May, June, Nov., Dec., Jan.	None	Dec.	June	Chicago Mercantile Exchange; New York Mercantile Exchange
Cocoa	30,000 lb.	.01 of 1¢ per lb.	$ 3.00	Mar., May, July, Sept., Dec.	Oct. 1 to Sept. 30	Jan.	June	New York Cocoa Exchange
Coffee	32,500 lb.	.01 of 1¢ per lb.	$ 3.25	Mar., May, July, Sept., Dec.	July 1 to June 30	None	None	New York Coffee and Sugar Exchange
Corn	5,000 bu.	$\frac{1}{8}$ of 1¢ per bu.	$ 6.25	May, July, Sept., Dec.	Oct. 1 to Sept. 30	Aug.	Nov., Dec.	Chicago Board of Trade; Kansas City Board of Trade; Minneapolis Grain Exchange
Cotton	100 bales (50,000 lb.)	.01 of 1¢ per lb.	$ 5.00	Mar., May, July, Oct., Dec.	Aug. 1 to July 31	July	Dec.	Chicago Board of Trade; New Orleans Cotton Exchange; New York Cotton Exchange
Cottonseed oil*	60,000 lb.	.01 of 1¢ per lb.	$ 6.00	Jan., Mar., May, July, Sept., Oct., Dec.	None	Jan., Feb.	Aug.	New Orleans Cotton Exchange; New York Produce Exchange
Eggs	14,400 doz. (carload)	.05 of 1¢ per doz.	$ 7.20	Oct., Nov., Dec., Jan.	None	Nov.	Apr.	Chicago Mercantile Exchange; New York Mercantile Exchange
Hides	40,000 lb.	.01 of 1¢ per lb.	$ 4.00	Mar., June, Sept., Dec.	None	None	None	Commodity Exchange, New York
Lard	40,000 lb.	.025 of 1¢ per lb.	$10.00	Mar., May, July, Sept., Oct., Dec.	None	Sept.	Apr., May	Chicago Board of Trade
Oats	5,000 bu.	$\frac{1}{8}$ of 1¢ per bu.	$ 6.25	May, July, Sept., Dec.	July 1 to June 30	May	Aug.	Chicago Board of Trade; Kansas City Board of Trade; Minneapolis Grain Exchange
Onions	30,000 lb.	.02 of 1¢ per lb.	$ 6.00	Nov., Jan., Feb., Mar.	No Standard	None	None	Chicago Mercantile Exchange; New York Mercantile Exchange
Soybeans	5,000 bu.	$\frac{1}{8}$ of 1¢ per bu.	$ 6.25	May, July, Sept., Dec.	Oct. 1 to Sept. 30	May	Oct.	Chicago Board of Trade
Sugar (domestic)	112,000 lb.	.01 of 1¢ per lb.	$11.20	Mar., May, July, Sept.	No Standard	None	None	New York Coffee and Sugar Exchange
Wheat	5,000 bu.	$\frac{1}{8}$ of 1¢ per bu.	$ 6.25	May, July, Sept., Dec.	July 1 to June 30	May	Aug.	Chicago Board of Trade; Kansas City Board of Trade; Minneapolis Grain Exchange

* Contract data for the New York Produce Exchange. On the New Orleans Cotton Exchange, the standard futures contract for cottonseed oil is 30,000 lb. with a minimum price variation of $3.00 per contract.

Source: Adapted from *How to Buy and Sell Commodities* (New York: Merrill Lynch, Pierce, Fenner & Beane, 1954), p. 43, and *Futures Market Service* (New York: Commodity Research Bureau, 1956), p. 8.

a speculative loss. Accordingly, he purchases a May futures contract in order to hedge the transaction.

On April 5, he purchases the cash grain, and at this time the price of spot wheat of the grade needed is $2.41, or 7 cents more than was anticipated on the basis of normal carrying charges from November to April. This speculative loss is offset by a similar gain in the futures market where the November purchase is closed out by a sale made on April 5.

Hedging in Other Commodities. The illustrations in the preceding paragraphs have been confined to wheat in order to simplify the discussion of hedging. Numerous commodity handlers, processors, and manufacturers in other lines, in which a futures market exists for the raw materials in question, also hedge. Hedging in other commodities does not require additional discussion or illustrations, since exactly the same principles are involved.

Among the most important of the commodities for which organized futures trading has been developed are butter, cocoa, coffee, corn, cotton, cottonseed oil, eggs, hides, lard, oats, onions, soybeans, sugar, and wheat. Various basic facts pertaining to each of these commodities are presented in Table 22, where are shown the standard futures contract size, the minimum price variation, the most actively traded futures months, the crop year, the normal seasonal price pattern, and the names of the important commodity exchanges where the products are traded. In addition to the commodities listed here, futures trading on organized exchanges is also carried on in connection with the marketing of certain other basic commodities which are listed in a later discussion of organized commodity exchanges.

Hedging Affords Incomplete Protection. It must not be inferred from the illustrations presented in this chapter that hedging affords complete protection against price changes or that it is always as simple as therein indicated. The illustrations in Cases I–IV were based upon the assumption of an ideal futures market. In such a market, theoretically, the price of a commodity for delivery in a futures contract month should show a premium sufficient to cover the cost of carrying the actual commodity through the intervening period including the month of probable delivery. When the futures price shows exactly such a premium over the spot price, it is regarded as a "perfect hedge," and watchful traders take advantage of the condition. Although such a relationship is the normal or long-run tendency of the market, it frequently happens that other factors operate to prevent the *principle of hedging* from working out as may be anticipated or desired.

Cash-Futures Prices Respond in Varying Degrees. In the first place, the futures and spot markets may not respond to conditions in exactly the same degree. Both prices may move in the same direction but in different

degrees and at different rates of speed, so that changes in prices in the futures market are not offset by exactly the same amounts of change in prices in the cash market. This may be due to the fact that a lower value may be placed at any time upon unidentified goods for future delivery than on goods which can be identified and delivered at once.

Furthermore, the cash commodity can often be sold on the basis of its quality at slightly more than the futures of the same grade, on account of the variations to be found between different goods even of the same grade. It is not at all uncommon for a merchandising terminal elevator, for example, to raise, say, 100,000 bushels of good No. 3 wheat to 115,000 bushels of low No. 2 by mixing the No. 3 wheat with 15,000 bushels of No. 1. In fact, mixing is one of the sources of profit to these elevators. Variations within a given grade are, therefore, quite numerous and significant. In most instances the chances are that if No. 2 hard winter wheat is purchased, the elevator future delivery will be the poorest No. 2 hard winter grain that can pass inspection as No. 2 grade. For this reason the seller's option as to grades to deliver tends, other things being equal, to place futures at a discount under cash.

Still another factor making for uncertainty in cash-futures price relationships is the activity of the government in accumulating supplies of agricultural commodities in connection with the administration of price-support programs or for purposes of export in connection with economic aid to foreign countries. Large-scale purchasing by the government has often resulted in price increases in spot grain without corresponding increases in futures prices. Because government purchases are irregular in nature and are not highly predictable, they result frequently in a situation where the spread between spot and futures prices is not consistent with the cost of carrying the commodity to the futures month. Consequently, the degree of protection afforded by hedging becomes somewhat uncertain.

The spread between cash and futures prices may also widen or narrow beyond normal expectations as a result of changes in interest rates, wages, and costs of storage. Suppose that an elevator purchases cash grain in September and hedges this by the sale of a December future, at a time when the spread is just equal to actual carrying charges of 2 cents per bushel per month, or 8 cents for the four-month differential. If all major elevator companies increase the charge for storage by one-fourth of a cent per bushel per month right after this hedge is opened, the normal effect would be to increase the spread by one cent, or to raise it to 9 cents.

The general effect of an unanticipated change in spread may again be stated in summary fashion as follows: *If the hedger is "long" in the spot market at the opening of a hedge, a widening of the spread brings a loss to the hedger and a narrowing of the spread brings an unexpected profit; if the hedger is "short" in the spot commodity at the hedge opening, a*

narrowing of the spread brings an unanticipated loss and a widening of the spread results in a "windfall" profit.

Although hedging is not a completely satisfactory or perfect means of shifting risk under the conditions discussed in the foregoing paragraphs, it is practiced, nevertheless, inasmuch as it is deemed desirable to risk the loss of a relatively small amount through fluctuations in the spread rather than to risk a larger loss because of major movements in the price level that result from changes in supply and demand conditions. There is, however, a large volume of hedging which is accounted for, not by fears of major or substantial changes in the price of the commodity traded in, but by the expectation on the part of the hedger of a favorable change in the relationship between spot and futures prices.[3] In view of the principle stated in the preceding paragraph, assume, for example, that a merchant had been accumulating a large stock of grain in September, at which time the price of December futures was at a premium higher than seemed justified by the cost of carrying grain in storage to December. Such a trader would anticipate that the spread between spot and futures prices would decline and he would be very likely to hedge, in expectation of a small speculative profit.

Relation of Raw Material to Finished Product. Hedging does not give full protection to processors or manufacturers if the necessary sympathetic and synchronous movements of raw commodity and finished product prices does not exist. Hedging affords a high degree of protection to elevator operators who eventually sell the same commodity as they place in storage. Similarly, it affords rather complete protection to the cotton merchants who absorb the surplus of the after-harvest movement and carry it in warehouses until needed by spinners and textile mills. The degree of protection available to manufacturers and processors is somewhat less as factors other than basic commodity prices become important in determining the price of the finished goods. The flour miller who hedges a stock of grain has a relatively high but only partial protection against changes in the price of flour. While the price of flour tends to move in a rather close relationship with the price of wheat, manufacturing costs also enter into the price of the finished commodity. The manufacturer of cornstarch also has a fairly high degree of protection through hedging in corn futures because the cost of corn, while not the complete cost of the finished commodity, is undoubtedly the most important starch price determinant. The price of raw cotton, however, is a considerably less important factor in the determination of prices for *finished* cotton cloth. Consequently, no full benefit may accrue to a textile mill from a policy of consistent hedging. The degree of protection afforded

[3] For a complete development of this aspect of hedging, see Holbrook Working, "Futures Trading and Hedging," *The American Economic Review*, June, 1953, pp. 314–43, especially pp. 320–27.

by hedging, other things being equal, may be said to vary directly with the importance of the raw commodity cost as compared with the cost of the finished product. Also, the degree of protection varies inversely with the duration of the manufacturing process. The longer the manufacturing process, the less is the protection because hedging over extended periods is somewhat unpredictable or, in some cases, impossible. When a short period, involving the same crop year, is under consideration, substantial speculative losses due to a change in the spread during the life of a hedge are improbable. The whiskey distiller, however, must age his product for a number of years and cannot very well hedge grain contracts against the future sale of the finished product some years hence.

Benefits from Hedging. Although the methods of hedging are quite different from those of fire or theft insurance, their economic functions are not dissimilar. Both result in a shifting of the risk to some one who is more willing or better able to assume it. Thus hedging affords *insurance against the risk of wide unfavorable price fluctuations.* This is the primary purpose of hedging. The net effect of such a shifting of risk is generally to minimize it, because the speculators who assume it are presumed to have superior knowledge of supply and demand factors.

The diminution of risks to both *middlemen* and *manufacturers* enables them to *operate on a smaller trade margin.* This in turn benefits farmers and other growers, who are not only given an opportunity to dispose of their products all at one time if they so desire, but to secure higher prices than would have been offered were it impossible for buyers to hedge and thus protect themselves.

Trade margins are kept down through hedging in still another way. The availability of a futures market *makes competition more effective, for it enables dealers to operate with relatively little capital.* The merchant with special skill and knowledge of his business but with comparatively little capital can trade more securely by means of hedging than otherwise would have been practicable, even though he hedges only when his commitments greatly exceed the volume of business warranted by the capital at his command. A comparison of the trade margins between producer and consumer on commodities that are usually hedged with those of commodities not thus protected will at once reveal the value of hedging. Consequently, the advantages of hedging inure to the benefit of both producer and consumer.

Another benefit is that *hedging facilitates financing of inventories of stored commodities.* Banks and other financial institutions are reluctant to advance large sums against purchases of raw materials whose values fluctuate considerably, as is true of practically all commodities adaptable to hedging. Even in the case of a firm that has a very good credit standing, a bank may lend only about 40 to 50 per cent of the value of an unhedged

commodity inventory. On the other hand, if the commodity is properly hedged, as much as 90 per cent of the total value may be safely loaned.[4] To lend money against unhedged products is somewhat analogous to lending on an uninsured dwelling. Hedging is a price "insurance policy" which makes the product thus protected readily acceptable as collateral. It is not only encouraged by bankers, but helps dealers and manufacturers to maintain a good credit standing through the elimination of "open" or speculative positions.

Organized Commodity Exchanges

Knowledge of organized speculation and hedging can be more fully gained through attention to the institutional mechanism whereby these activities are accomplished. The following discussion is concerned solely with the major exchanges that provide facilities for futures trading, the character of the operations of a large exchange, and the control of exchanges by government.

Commodity Exchanges with Facilities for Futures Trading. There are a number of important commodity exchanges in the United States that furnish continuous cash and futures markets in basic commodities. These are listed below, together with the commodities for which futures trading facilities are available:[5]

Chicago Board of Trade: corn, cotton, lard, oats, rye, sorghum (grains), soybeans, soybean meal, soybean oil, and wheat
Chicago Mercantile Exchange: butter, eggs, onions, potatoes, scrap iron and steel (inactive), and dressed turkeys (inactive)
Commodity Exchange, Inc. (New York): burlap, copper, hides, rubber (crude), tin, zinc
Kansas City Board of Trade: corn, millfeeds, oats, rye, sorghum (grains), wheat
Memphis Merchants' Exchange: cotton seed meal, soybean meal
Minneapolis Grain Exchange: corn, flaxseed, oats, rye, and wheat
New Orleans Cotton Exchange: cotton, cottonseed oil
New York Cocoa Exchange: cocoa beans
New York Coffee and Sugar Exchange: coffee, sugar
New York Mercantile Exchange: eggs, onions, potatoes
New York Produce Exchange: cottonseed oil, soybean meal, tallow

Operation of a Major Exchange. While the above-listed exchanges differ considerably in size and detail of organization, all of them are somewhat

[4] Paul E. Berry, "The Speculator and the Commodity Futures Market," *Proceedings, Eighth Annual Symposium*, Chicago Board of Trade, 1955, p. 6.

[5] There are also a number of other commodity exchanges organized for the purpose of providing market information or facilities for cash markets for produce and livestock, but these are not within the scope of the discussion in this chapter.

similar in terms of purpose and function. Something of the character of their operation is revealed by detailed consideration of the largest and most important of them, The Chicago Board of Trade.

It was not until 1848 that the first American grain exchange, the Chicago Board of Trade, was organized. Ten years earlier the first shipment of grain into Chicago consisting of 78 bushels had arrived. Disorganized market conditions and the cost of transportation limited the price of wheat to 40 cents per bushel in Peoria when the Chicago price was $1. Hence it was felt that rules for the government of the trade should be established and the exchange was formed. Since that time the exchange has furnished facilities for trading and rules for the trade as a whole, but it does no trading itself. Continuous futures trading on this exchange in wheat, corn, oats, and lard has been carried on since 1859, and in barley and rye since 1865. In the 1930's cotton was added, and later trading in soybeans was begun.

The exchange owns a large office building and has an affiliate, the Board of Trade Clearing House, which furnishes the machinery for clearing trades among the members, and in the event of contract defaults by a member it takes over his contracts and carries them to completion. Thus no one trading on the exchange can lose because of the inability of a trader to carry out his part of a bargain made under its auspices.

The Chicago Board of Trade is a typical exchange in that it furnishes a meeting place for the various elements of the commodity trades. Membership is limited in that a new membership is usually acquired by purchasing the privilege from some party desiring to sell it. Exchange membership is a personal privilege enjoyed directly only by individuals; corporations and partnerships are not members but conduct their trading operations through individuals who hold memberships. These individuals may be commission traders, or employees or representatives of commodity handlers or processors. In a recent year, the total membership exceeded 1,400. The cost of operating the exchange is financed by annual membership dues.

"Cash" and "Futures" Markets. The grain exchanges maintain both a "cash" and a "futures" market. It is thus always possible to buy or sell for cash or for any one of the five principal futures months for a price which tends to equalize demand and supply. An illustration may help to explain the mechanics of the transactions taking place in the futures market. Assume that some one in a city other than Chicago wishes to buy a future. He may be a miller, a feeder, a grain elevator operator who wishes to hedge a sale, an exporter, or just a speculator. The procedure in all cases is the same. His first step is that of telephoning to his broker located in the same or some nearby city and giving the order, say, to "Buy 10,000 May wheat at the market." The broker places the slip before his telegraph operator at once. Almost immediately it is reproduced in a Chicago brokerage office, tele-

phoned to the floor representative of the broker, written on a slip of paper, and sent by messenger to the trading member in the wheat "pit," i.e., the area in which all trades are transacted (see Figure 6). Since the order was to buy "at the market" it can be executed at once, unlike "limited orders" on which a price is stated as well as the time limit within which it is to be executed.

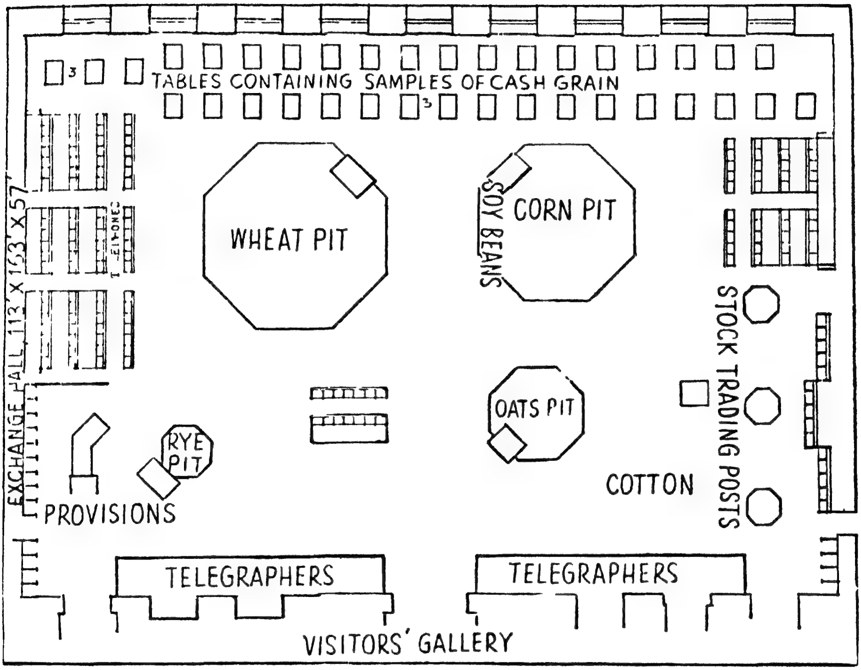
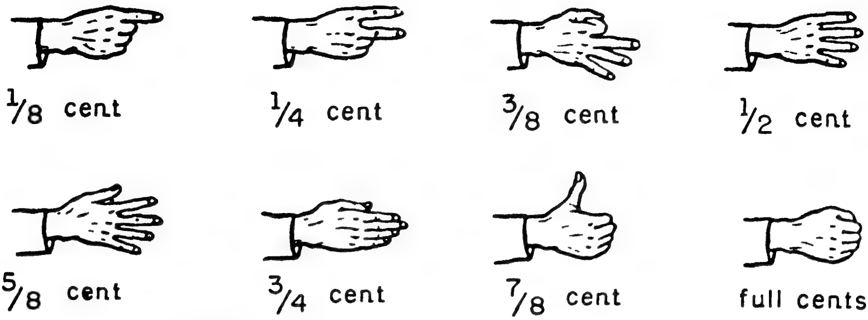


FIG. 6. Floor plan of the Chicago Board of Trade.

The trading member in the pit extends two fingers of one hand, at the same time placing the hand so that the palm is inward. This is evidence to all that he is offering to buy 10,000 bushels of wheat, since each finger represents the basic trading unit, 5,000 bushels, and a palm held outward is an offer to sell and inward is an offer to buy. The exact price is indicated by the position of the fingers and thumb of the other hand, the code used being illustrated in Figure 7. It is always understood that the fractional cents indicated are either above or below the current quotation as indicated by still other code signals. Buyers accept or make a counter offer by similar signals.

Uniformed reporters stationed in stands above the pits watch each offer to sell or to buy, and when a deal is consummated they enter the futures month and the amount by which the transaction exceeded or was below the current quotation. These changes are at once transmitted to a central con-

trol room from which they go by tickers and private wires to over 600 American cities. At the same time the change is transmitted by a Morse code operator in the control room to blackboard markers so that it may be posted on a blackboard on the exchange floor. Confirmation of the purchase is



Price signals showing changes in price per bushel from preceding price quotation.

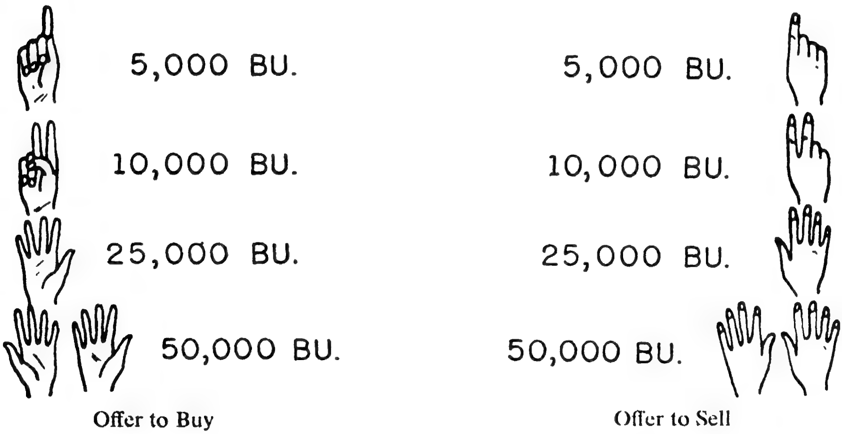


FIG. 7. Signals used in futures trading on the Chicago Board of Trade (made necessary to overcome the confusion resulting from the "outcry" of bids and offers by the multitude of traders in the pit).

sent by the floor trader to the floor representative of the broker and on to the buyer through the same channels which the order traveled in reaching the exchange floor. Orders have left Minneapolis or Kansas City, been executed, and confirmed to the point of origin in less than one minute. Orders from London have been transmitted, executed, and confirmed in two minutes. If the order had been for an odd or job lot, i.e., an amount less than 5,000 bushels, it would have been purchased from an "odd lot man," one who deals in less than the standard unit, but always in units of 1,000 bushels or multiples thereof.

Futures sales of grain are made for delivery in one of five months of the year, namely, July, September, December, March, and May.[6] Because of the fact that a buyer of a futures contract may decide to sell it in advance of the time of delivery, the actual number of transactions is very large, the number of bushels sold on the various exchanges each year being several times the size of the actual crop.[7]

The Exchange Clearing House. Like other principal exchanges, the Chicago Board of Trade has an affiliated organization known as the Clearing House. Its function is identical with that of the clearing houses which serve the banks of all larger cities, namely, a simplification of settlement of balances by use of the offsetting principle.

At the end of each trading day every member of the Board of Trade, either directly or through another member of the exchange who is also a member of the clearing house, submits a sheet showing all transactions by the member for that day.

At the close of the trading session, the clearing house establishes a settlement price which is approximately the closing price of the commodity for the day, and all transactions of the day are computed as against that price. For example, if one member sells to another 5,000 bushels of grain during the session at $2 per bushel and the closing price or settlement price reaches $2.01 per bushel, the buyer may be said to have made $50 and therefore credits himself with this difference on his clearing report; and on the other hand, the seller may be said to have lost $50 and therefore debits himself in that amount. The same operation is performed with all transactions in the various commodities dealt in, and each member upon the completion of his clearing report covering his day's dealings then either pays to or collects from the clearing house one sum which adjusts all of his transactions to the settlement price.

When a clearing member's purchases exceed his sales or vice versa, he is said to have an open interest to the extent of that difference in that particular commodity, and he is either long or short that amount to the clearing house. These contracts are carried by the clearing house, and to secure the performance of such contracts the clearing house requires a deposit of cash or government securities at a certain rate per bushel. As a clearing member's open interest decreases, proportionate amounts of such margin deposits are released to him.

[6] Winter wheat reaches the markets in July and spring wheat in September. December marks the close of lake navigation, while May sees it opened. March is of importance as a delivery month as it divides the long period between December and May.

[7] In the 1954 crop year, for example, total United States production of wheat was 907 million bushels. For the same crop year, the volume of trading in futures contracts amounted to 4,763 million bushels. See, *Statistical Abstract of the United States* (Washington, D. C.: Government Printing Office, 1955), pp. 467 and 667.

When delivery of a commodity is tendered the clearing house by a member who is short on the books of the clearing house, the clearing house allocates such delivery to the member who is obligated by the oldest contract on the long side. Such long then pays the proceeds of the delivery to the short, both members reduce their open interest by the amount of the futures contract, and it is so settled on their clearing house report.

To make contracts on the exchange, the clearing house assumes all obligations of members who default in the performance of their contracts for financial or other reasons, by taking over their business and making settlement with all persons holding contracts with the defaulting members.

Other Exchange Functions. Because of this constant buying and selling of contracts, one of the services of the exchange is the provision of a continuous market at all times for all of the commodities so handled. Since any one can buy or sell through a broker or commission merchant, the market is an open one and not subject to monopoly. In order that members may estimate the factors which will affect future prices, exchanges collect many items of pertinent information and make them available to the membership. Inasmuch as most futures contracts are fulfilled by the delivery of warehouse receipts, showing that grain is in storage in a certain elevator, exchanges have been forced to supervise the methods used by the elevators in grading the grain stored with them. In so doing, the exchanges have contributed to the establishment of definite grades which are accepted as the standard for the grain trade everywhere, a service that is distinctly advantageous.

Control of Exchanges. Because of the great social importance of the commodity exchanges, they have been subjected to special forms of governmental controls. The first such controls were imposed by the Cotton Futures Act of 1915 and the Grain Futures Act of 1922. Important objectives of this legislation included: (1) removal of the mystery from futures by requiring records to be kept and subject to inspection, (2) prevention of dissemination of false or misleading information with a view to affecting prices, (3) prevention of corners and other misuses of the facilities of the exchange, (4) making contract markets more open by declaring it illegal to refuse membership to cooperative associations or commission houses owned cooperatively, and (5) limiting trading to boards of trade located at terminals which have official inspection service and other satisfactory marketing conditions.

This legislation was superseded in 1936 by a more inclusive and somewhat more stringent law known as the Commodity Exchange Act. The 1936 law retained the original features of the earlier legislation but broadened its coverage by including all transactions involving wheat, cotton, rice, corn, barley, rye, flaxseed, sorghums, millfeeds, butter, eggs, and potatoes. Subsequent amendments passed by Congress in 1938 and 1940 brought futures

trading in wool, lard, tallow, cottonseed oil, soybean oil, cottonseed meal, cottonseed, soybeans, and soybean meal within the scope of the Commodity Exchange Act. One of the most important additional provisions is that the Commission which was established to administer the law shall have the power to set limits to advances or declines in the market in any one day. Such limits vary from commodity to commodity but may be illustrated by wheat for which the limitation has been set at 10 cents per bushel. If the market advances or declines by that amount in a day's trading, operations are suspended for the remainder of the day. This provision is designed to prevent great temporary changes in the market that are probably not justified by changes in supply and demand conditions—changes that are attributable rather to temporary panic or elation growing out of psychological reaction to crop reports, government activities, world conditions, and so on. Similarly, the Commission may set daily limits to the amount of trading by any one person, except for actual hedging transactions, probably intended to curb tendencies to create a corner or squeeze. For example, in the case of wheat, no one may have a net open *speculative* position for a futures month or combination of futures months that exceeds 2,000,000 bushels, nor may he buy or sell in excess of that quantity of futures in any one trading day; in the case of rye the comparable trading limit is 500,000 bushels, and for cotton it is 30,000 bales. In addition, the Secretary is empowered to establish other rules necessary to effectuate the provisions of the Act.

It is generally conceded that the law has proved beneficial. Its provisions and the administrative regulations that have been promulgated for its enforcement emphasize the normal economic functions of commodity exchanges and, at the same time, operate to curb drastically or to eliminate certain of the abuses of speculation that were discussed in the preceding chapter.

Commodity Exchanges and Public Price Policies. The importance of organized commodity exchanges has diminished somewhat since the 1920's, and has varied from time to time since then, as a result of the impact of various types of governmental policies which are pursued for the purpose of supporting or regulating prices. Speculation flourishes to the greatest degree in free markets in which prices are subject to the full impact of supply and demand forces; similarly, the need for hedging through commodity exchange facilities is greatest under such conditions.

During periods of war or national emergency when the government has engaged in rationing and price regulation programs, speculation and hedging have been of relatively little importance. During World War II, for example, futures trading in metals and certain other commodities was entirely suspended; and in cases of some commodities where futures trading was continued, the volume was at a very low level.

In non-war years since the early 1930's, when the government began to support prices of basic farm commodities and thus insured that they would not fall below a certain level, market risk in such commodities has been less than formerly. This has been reflected in the volume of futures trading. In 1925, in the absence of government price-support programs, the volume of trading in all major grain futures was at an all-time high, surpassing 30 billion bushels; but in 1939, after several years of experience with public price-support programs, the volume was less than 9 billion bushels. Even in the very prosperous early 1950's, the volume of trading in grain futures was far below the level of the 1920's, amounting to only about 8 to 9 billion bushels annually.[8] In spite of the lesser degree of market risk under conditions of government support of many basic commodity prices, such prices are still free to move over a very considerable range and are among the most sensitive of all prices in the economy. Thus, commodity exchanges continue to render valuable service by providing facilities where organized speculation and hedging are carried on and their benefits, therefore, are brought to the whole of our society.

Questions and Problems

1. Define each of the following terms:
   a) trade profit
   b) speculative profit
   c) normal futures market
   d) spread
   e) carrying charge
   f) hedge
   g) perfect hedge
2. How do you account for the fact that not one wheat farmer in 500 engages in futures trading?
3. Is the effect of hedging to:
   a) Encourage or discourage speculation?
   b) Reduce, eliminate, or merely shift market risk?
   c) Widen or narrow trading margins?
   d) Facilitate or hamper the financing of inventories?
4. Explain the steps which our government has taken to control futures markets and futures trading.
5. "Hedging is insurance: it guarantees that the hedger will have no speculative loss if he gives up the opportunity for making a speculative profit." Evaluate this statement.
6. Explain how government price policies have been related to the volume of speculative activity and hedging in basic commodities.
7. Mr. Smith is a winter wheat farmer in western Kansas. In normal years he plants about 25,000 acres in late September and starts combining in late June. His average yield is about 12 bushels per acre. Does hedging afford

[8] *Statistical Abstract of the United States* (Washington: Government Printing Office, various years). Data include wheat, corn, oats, and rye.

protection to Smith against price declines? Should he hedge? If he wishes to hedge, how should he go about it? When should the hedge be placed and when should it be closed out?

8. Mr. Smith's neighbor says that Smith is foolish to hedge. His argument is as follows: "When prices are high, yield is low; when prices are low, yield is high. Without hedging, total income will thus remain about the same from year to year. If you hedge, you make a killing when crops are good, but you suffer when crops are bad." What assumptions with regard to production and demand underlie the above statements? Do you agree? Explain fully.

9. Secure the most recent issue of a daily paper which contains a good financial section. What prices are listed for corn? For wheat? Explain each. What should be the normal relationship between the cash and the futures prices? Does this relationship exist here? If not, explain factors which may have disturbed such relationship.

10. On October 12, the Farmers' Elevator Company purchased 20,000 bushels of No. 1 hard spring wheat from farmers in the surrounding territory. This grade was selling in the Chicago cash market at $2.40 per bushel. In order to allow for a satisfactory trading margin, the elevator company paid farmers $2.24 per bushel for this grain. Officials of this company felt that the risk of price fluctuations was too great to bear, so they decided to hedge. On this day, December futures were quoted at $2.45 and May futures at $2.54. On October 31 the above grain was sold to a milling concern at $2.47 per bushel. Terms: To arrive, 15 days. At this time December futures were quoted at $2.51 and May futures at $2.60.

    Outline the necessary steps to be taken by the Farmers' Elevator Company if it wished to keep fully hedged. Was this a perfect hedge? Explain. What was the gross profit obtained by the Farmers' Elevator Company on this entire transaction?

11. John Brown of Bismarck, North Dakota, wishes to buy 10,000 bushels of "December" corn on the Chicago Board of Trade. He knows that the closing price on yesterday's market was $1.62½ and he does not wish to pay more than this amount. What would he do? Trace this transaction through the exchange and back to Mr. Smith, explaining each step.

12. On November 10 you discover that "May" barley futures are selling at $1.26 per bushel while cash grain of contract grade is selling at $1.14. Assuming storage costs to be 1½ cents per month, what could you do to earn yourself a profit?

13. On September 12 a miller sold a large shipment of flour which will require 15,000 bushels of wheat. The price was based on the current quotations of grain. The miller did not, however, immediately purchase the wheat to be used in grinding this flour. He did not intend doing so until February, because delivery of the flour was not to be made until April 3. Explain how this miller could protect himself against a rise in price by hedging.

29

MARKETING INFORMATION AND RESEARCH

In performing the huge and complex task of marketing there is an almost endless number of varied problems calling for factual information as a basis for sound solutions. Each marketing entrepreneur is faced with a wide variety of managerial problems that require correct solutions if profits are to be maximized or losses minimized. Some of these problems are unique or peculiar to an individual business enterprise or situation, some apply to a given industry or line of trade, whereas others are common to all marketing concerns. From a broader viewpoint, there are also social problems incident to marketing activity; these, too, must be solved satisfactorily if public welfare is to be enhanced. Some of the social problems frequently center around the feasibility of enacting, amending, or repealing specific legislation.

Regardless of the narrow or pervasive scope of particular marketing problems, sound solutions call for the effective performance of an important marketing function, namely, that of *collecting, analyzing, and interpreting through research activity, marketing information which is disseminated to those charged with the responsibility for making decisions in the marketing field.*

The Need for and Meaning of Marketing Research. Many specific managerial problems in marketing. as well as those concerned with the more general aspects of marketing policy or strategy, can be solved on the basis of available information and existing knowledge. Past experience and previous research, coupled with sound judgment, have made possible the development of principles and rules of conduct that provide ready answers in a

great many situations. New and unusual situations continually arise, however, and some old ones appear in new and even strange forms and under substantially different circumstances. In such cases, sufficient information or knowledge is not likely to be at hand as a basis for an intelligent solution. Instead, one of two general courses of action may be taken. One is to make a guess or perhaps an estimate of the situation and hope that it is the correct solution. The other involves the obtaining of necessary information in order that a reasonably accurate decision may be made on the basis of facts and sound application of principles. The latter course of action entails the utilization of marketing research, because *the essential purpose of marketing research is to provide the necessary information or knowledge on which to base sound decisions in the solution of marketing problems when readily available information is insufficient or completely lacking.*

Illustrations of situations where available knowledge and established principles are adequate for soundly conceived action are numerous and varied. The large-scale flour miller, for example, receives regularly the crop reports of the United States Department of Agriculture. It is well known that such information, which relates to probable future supply, is an important factor influencing the price of grain. The interpretation of this information, in the light of accumulated experience in the trade, makes possible more intelligent decisions with respect to inventory acquisitions than could be made in the absence of such market information. A second situation may be illustrated with respect to the case of a new and fairly small vegetable canning factory in a specialized producing region. Because the production is seasonal, the line of merchandise is small, and the potential market is widely scattered, knowledge of available principles indicates the use of brokers in the channel of distribution. Many additional examples of this kind could be cited. In all such cases, however, if general principles are not available, it becomes necessary to make a guess or to conduct a research investigation in search for the answer. The individual entrepreneur or manager who makes decisions on the basis of established principles owes his ability to make such decisions to the past research activities of marketing students or practitioners whose efforts have resulted in the formulation of the principles or have provided accessible information as a guide in determining the course of action.

When principles are lacking or when available knowledge and information are less than deemed adequate for arriving at sound management decisions, it is the accepted function of marketing research to supply the necessary facts. Marketing facts comprise the information or knowledge requisite to the formulation of general principles, or more narrowly, to the sound solution of marketing problems within particular trades or institutions in a given situation. It is the task of those engaged in marketing research to determine what facts are needed, where and how they are to be assembled,

how they are to be described and classified, what hypotheses are warranted by them, how those hypotheses can be verified by the assembly of additional facts, how those facts are to be finally interpreted, and what application may be made of the results.

From the foregoing discussion, the meaning of marketing research should be clear. It may be defined as *any purposive investigation which has as its objective the obtaining of knowledge of any business activity necessary to effect transfers in the ownership of goods or to provide for their physical distribution.* This covers research involving any *market,* marketing *institution,* marketing *function,* marketing *cost,* or marketing *policy.* It applies equally to information obtained originally from the field, as in the case of a consumer questionnaire survey or an enumeration of business establishments, and to analyses of quantitative data and qualitative information available in published sources or in the files of the business enterprise, so long as the purpose of the investigation is that of adding to the fund of currently existing knowledge about the subject of inquiry.

Sources of Marketing Information

There is an all-too-prevalent idea that marketing research is concerned primarily with the collection of information through the conduct of surveys of ultimate consumers or business establishments. While there are numerous specialized marketing research organizations that are engaged principally in research work of this kind, by far the greater part of the quantitative data and qualitative information used in the research activities of marketing establishments is available in published form from governmental and private information sources. It is believed that the more widespread application of research procedures is not so much affected by the nonexistence of relevant information as it is by the fact that businessmen and marketing students generally are not well informed regarding the sources from which such information may be obtained. In this and the following section of the chapter, attention is directed to some of the more important available sources of marketing information.

Government Sources. In some way or another, government agencies are involved in the performance of all of the marketing functions. This involvement ordinarily is of a regulatory or facilitating nature, as indicated by references to various types of legislation discussed in the preceding chapters in connection with the other marketing functions. Marketing information, however, presents a rather unusual situation in the sense that the government assumes a much more active role in the performance of the function. This participation is based upon the premise that the structure and functioning of free markets are dependent upon millions of decisions made by

countless individuals in various kinds of marketing agencies. All such decisions are based upon some kind of information, which may be highly accurate or, in some cases, quite unreliable. Obviously, the decisions can be no sounder than the information upon which they are based, and the functioning of the whole economy can be no more efficient than the aggregate of the individual judgments which enter into it. Thus, in the interest of marketing efficiency and in behalf of the general welfare, the government engages in various kinds of programs to provide on a widely disseminated basis adequate information relating to marketing and other business activity. The amount and variety of such information are so great and significant that complete books have been devoted to the subject.[1] Thus, the present discussion is to be regarded as merely illustrative.

Census Information. Through periodic censuses conducted by the federal government, detailed information is collected by a complete enumeration of some of the most important sectors of the national economy. Census data are provided for a variety of reasons and are widely used for a large number of business, economic, political, and other social and individual purposes. From the standpoint of marketing interest, they supply most of our basic knowledge about the institutional structure for marketing and the composition of national and local area markets.[2]

The Census of Agriculture, scheduled to be taken every five years, provides an inventory of the nation's resources for agricultural production. In it are to be found complete data pertaining to the manner in which agricultural resources are used and the kinds and amounts of production on our some 6 million farms. Data are compiled and presented in such a way that many kinds of information are available for counties and often for minor civil divisions within counties. Such statistics are of great importance not only in connection with agricultural marketing, but in delineating various kinds of markets for industrial goods which are purchased by farmers.

Most of our knowledge of the marketing structure has come from the various Censuses of Business which have been taken irregularly since 1929, but which are scheduled to be taken every five years under existing legislation. Liberal use has been made of statistics from these Censuses throughout this volume. Coverage is provided for wholesale, retail, and service trades. Among the kinds of available information are data on the following major subjects: number of establishments, sales volume, merchandise inventories, credit sales, payroll, operations of multi-unit organizations, legal form of organization, sales volume classifications, tabulations by various forms

[1] *Cf.* Philip M. Hauser and William R. Leonard, *Government Statistics for Business Use,* 2d ed. (New York: John Wiley & Sons, Inc., 1956).

[2] For a detailed treatment of marketing applications of Census data, see Neil H. Borden, *et al.,* "An Appraisal of Census Programs for Marketing Uses," *The Journal of Marketing,* April 1954, pp. 331–60.

or methods of operation, and operating expenses for wholesale trade. A considerable quantity of data for individual lines of trade is presented for each city of more than 2,500 population (5,000 for wholesale trade), each standard metropolitan area, each county, and each state. Such information is invaluable in determining trends by lines of business, by method of operation of marketing institutions, and by regions or local areas.

The Census of Manufactures has been taken at irregular intervals since 1810 and, like the Census of Business, is scheduled to be taken in the future at five-year intervals. It provides for a complete enumeration of the activities of all manufacturing establishments. Information is available, partly on a national and partly on a local area basis, relating to value of shipments, value added by manufacture, input of labor, consumption of fuel and important materials, value of inventories, expenditures for plant and equipment, and, for some 6,000 individual commodities, the value of production. Such statistics provide benchmark data indicative of changes in the volume of production and demand for individual commodities, changes in the number of establishments engaged in particular types of manufacturing, and regional or local area shifts in industrial location. This Census is the best available source of information for determining the magnitude and location of the markets for many kinds of goods purchased by industry.

Censuses of Housing and Population are taken decennially and the information thus secured is of great value to marketers of goods. National and local area statistics from these Censuses are used to determine the size and character of markets in terms of number of residents or consumer units (households). Valuable information on growth trends is available by comparisons with data from former Censuses which, in the case of some subjects, date back to 1790. For many marketing purposes, it is extremely important to know much about "kinds of people" as well as their number. Data are therefore available, even for small local areas, for such population characteristics as sex, age, color or race, nativity, urban-rural residence, marital status, educational level, occupational and industrial classification of those in the labor force, family income, family status, and general characteristics of housing.

Current Marketing Facts. Between the intervals of the various kinds of censuses, there is much need for current information. Various government bureaus and administrative agencies devote much effort to monthly, quarterly, or annual compilations of statistics, collected on the basis of sample studies and covering generally the same areas as reported in the censuses.

The U. S. Bureau of the Census issues a large number of short publications each year in a series entitled "Current Population Reports" that includes, among others, the following: *Population Characteristics,* which covers items such as marital status, household characteristics, and population mobility;

Population Estimates, which provide data on the size of the population nationally and by states, current estimates by age, sex, or color, and population projections for future years; and *Consumer Income,* which reveals the current income of persons and families.

An *Annual Survey of Manufactures* and monthly or quarterly *Facts for Industry Releases* are published by the Bureau of the Census to provide businessmen with information on short-term developments. For many specific industries, data are presented on production, shipments, consumption of materials, unfilled orders, stocks, and utilization of machinery and equipment. Such information guides marketing executives in determining policies that should be followed in regard to current inventories, or in deciding what kinds of markets merit special sales attention.

The Survey of Current Business, which is published monthly by the Office of Business Economics of the U. S. Department of Commerce, is one of the most highly valued sources of current marketing information. It usually contains about 40 pages of statistical data, and several special issues each year are more comprehensive in their coverage, as is the biennial supplement on "Business Statistics." Among the more significant facts regularly reported are industrial production, national and consumer income, personal consumption expenditures, price indexes, sales and inventories in wholesale and retail trade by kinds of business, advertising activities, transportation and communications activity, and production by industrial classifications.

The *Federal Reserve Bulletin,* published monthly by the Board of Governors of the Federal Reserve System, contains detailed statistical information on department store sales and stocks by regions of the country and by departmental breakdowns. Among other current facts of marketing significance are data on consumer credit extensions and indebtedness, business finance, foreign trade, and prices. Regular articles in this publication deal with summaries of business conditions and provide interpretations of current conditions that are valuable in judging probable future developments.

The *Monthly Labor Review* and other publications of the U. S. Bureau of Labor Statistics are of interest to marketing, chiefly because of the data they contain on wholesale prices, retail prices, cost-of-living index, housing construction, nonresidential construction, and changes in the labor force.

Much of the information collected by the aforementioned and other government agencies is published annually in summary form in the *Statistical Abstract of the United States,* which is valuable not only for the facts published therein, but also for the source notes indicating the agencies which collect other kinds of relevant marketing information.

Certain state bureaus are a source of information to businessmen. The highway departments of the different states, for example, furnish information on proposed new construction, the kind of materials which will be

used, dates on which contracts will be let, etc. Municipal offices, including those of the buildings inspectors, have records which are of interest. Contractors are interested in knowing what building permits have been issued and to whom, for such information guides them in their sales activities. Manufacturers of certain kinds of household and building equipment are also interested in building permits. Records of transfers of deeds may be very important, as are other court records, including wills filed for probate, marriage licenses, records of attachments, dealer licenses issued, automobile licenses, and similar items.

Special Information Services for Agricultural Commodities. Government activity in collecting and disseminating marketing information has been of unusual significance in the case of agricultural commodities. Data pertaining to the current condition of more than 150 principal crops and livestock products are furnished regularly by the Crop Reporting Service of the Agricultural Estimates Division of the U. S. Department of Agriculture.[3] Crop reports include estimates of the acreages that farmers intend to plant, acres planted for harvest, monthly estimates of probable production based on crop conditions and probable yields per acre, and production actually harvested. In the case of livestock and poultry production, estimates are made of the number of animals on farms and the intentions of farmers with respect to subsequent seasons. Such information is collected through the cooperation of 39 state governmental agencies or agricultural colleges. Each year, on the average, about 600,000 farmers and 175,000 other persons make reports which enter into the compilation of the published data.[4]

Information relating to current supply and price conditions in approximately 100 important wholesale market centers is provided by the Market News Service of the Department of Agriculture. Daily information about market conditions for staple agricultural commodities, fresh fruits and vegetables, and livestock is collected by reporters in each market. Local market offices all over the United States are connected by about 11,000 miles of teletype circuits so that each local market office is in contact with all others several times daily. Through a consolidation of reports, five large area offices prepare and release information to the press and radio three times daily. Data from such reports are regularly featured as news items on broadcasts from over 1,500 radio and television stations and are published on the market pages of about 1,100 newspapers.[5] Through such facilities, traders in any one market know about price and supply conditions in that market, in other markets, and at important shipping points, as well as the volume of unloadings or diversions in transit at each principal terminal market.

[3] *Marketing: The Yearbook of Agriculture* (Washington, D. C.: Government Printing Office, 1954), pp. 175–76.

[4] Philip M. Hauser and William R. Leonard, *op. cit.*, p. 117.

[5] *Marketing: The Yearbook of Agriculture, op. cit.*, p. 179.

In addition to the foregoing types of information releases, the Department of Agriculture regularly publishes a number of so-called "situation reports" which provide a rather complete picture of the current and prospective supply, demand, and price situation for the agricultural economy as a whole and for important individual commodities. The character of these publications is suggested by the following titles: *The Demand and Price Situation, The Agricultural Situation, The National Food Situation, The Farm Cost Situation, The Farm Income Situation,* and *The Marketing and Transportation Situation.*

It is sometimes erroneously assumed that marketing information disseminated through agencies of the U. S. Department of Agriculture is of interest principally to farmers. Actually, such information is used no more extensively by the farmer, and in some cases less extensively, than by speculators on the major commodity exchanges, assemblers or local market buying middlemen, primary handlers or processors such as cotton gins or tobacco warehouses, manufacturing companies such as bakeries or tobacco manufacturing companies, wholesale distributors, large retailing organizations, and agencies that provide ultimate consumers with buying information.[6]

Special Government Studies of Interest to Marketing. In the foregoing paragraphs, attention has been directed to information that is *regularly* compiled and disseminated by government agencies. There is, however, a wide range of special studies which are made at times and upon occasions that the public interest seems to justify. Illustrative are the *1950 Survey of Consumer Expenditures,* conducted by the U. S. Bureau of Labor Statistics, which provides detailed spending information for families in urban America; *Selling the United States Market,* a guidebook by the U. S. Department of Commerce, which provides information about methods used by manufacturers in developing and selling products; and *Fluid Milk and Cream Consumption in Northeastern Marketing Areas, 1940–54,* a U. S. Department of Agriculture Marketing Service publication, providing an historical record of marketing and consumption as suggested by the title. In this regard, the contributions of the Federal Trade Commission must not be overlooked. So voluminous is the marketing information made available by the government and other sources that the U. S. Department of Commerce publishes a monthly magazine, *Distribution Data Guide,* which usually contains more than 100 annotated references to selected current marketing studies, and in this manner brings them to the attention of interested parties who subscribe to the service.

Marketing Information Through Cooperative Activity. Much valuable marketing information reaches business establishments as a result of co-

[6] *Cf.* Stanley Andrews, "What Information Do Farmers Want and Use?" in *Market Information* (Washington, D. C.: Department of Agriculture, 1954), p. 70.

operative activity through which the members of some group share it. Two very significant variations of this character include trade associations and cooperative marketing organizations.

Trade Associations. Trade associations representing retailers, wholesalers, and manufacturers in the same line of business have long played a very important role in gathering and publishing information which is of value to their members.[7] Through regular and special publications, reports upon various kinds of research activities are made available to members and, in some cases, to the general public. Surveys of typical operating ratios, studies of business techniques and procedures, the dissemination of current news of interest to the trade, and educational activities are among the numerous functions of the more important associations.

Cooperative Marketing Organizations. One of the important services of cooperative marketing organizations is that of collecting and disseminating marketing information to promote orderly marketing for the benefit of the membership. An example is provided by Florida Citrus Mutual, an organization with a membership of 7,200 citrus fruit growers. Growers are divided into 39 council groups. Officers are invited to headquarters in advance of each marketing season. At this time, officials present all available information relating to supply and demand conditions which will have a bearing upon the average price for the growers' fruit during the season. Such information is provided for each type of utilization, including fruit for fresh shipment, canned juice, and frozen concentrate. Throughout the season, a special weekly publication is sent to all members, advising them of all up-to-date information deemed to be of significance in the marketing of fruit available for disposition.[8]

Private Sources. Public and cooperative sources of marketing information are supplemented by a wide variety of private sources. Some of the more important of these are indicated in the following paragraphs.

Trade and Professional Magazines. One of the most significant sources consists of trade or professional magazines or business papers. Most people have seen a few such publications as a matter of ordinary experience, but very few persons have any real knowledge of the vast number that is published regularly. In one source, over 2,000 different trade or professional magazines are indexed and described.[9] Some of these are of rather general

[7] All trade associations in the United States together with the kinds of activities carried on by each are listed in Jay Judkins, *Directory of National Trade Associations* (Washington, D. C.: Government Printing Office, 1956).

[8] For a more detailed account, see Robert C. White, "Use of Supply-Demand Analysis in Industry Marketing Programs," *Market Information* (Washington, D. C.: Government Printing Office, 1954), pp. 96–100.

[9] *Industrial Marketing,* "Market Data and Directory Number," June, 1955.

interest and are read by executives and operating personnel in a variety of positions in all kinds of industries. Examples include *The Journal of Marketing, Business Week, Distribution Age, Fortune,* and the *Harvard Business Review.* Certain magazines contain information of special significance to those charged with the responsibility of a particular function, which is the case with the periodicals *Credit and Financial Management, Sales Management,* and *Purchasing.* Many of them are primarily of interest to those in some particular line of trade or type of industry as suggested by the titles *Frozen Food Age, Men's Wear, Steel, Oil and Gas Journal, Hardware Age,* or *Building Supply News.* Some are of national significance, while others are of mere local or sectional interest as illustrated by the titles *Kansas City Grocer, New England Appliance and Television News,* or *Michigan Drug Journal.*

Trade magazines are of interest for several reasons. First, they contain discussions of research activities and expert or editorial appraisals of current marketing developments. Second, many provide continuing feature columns or sections which contain reports of trade statistics, legislative developments or other matters. Third, the trade advertising that they contain is informative in itself. Finally, many of the major publications have special annual issues, of which the following are of unusual significance:

> *Sales Management,* "Survey of Buying Power Issue," published annually on May 10. Contains current estimates of population, disposable family income, retail sales in total and by five store groups for cities over 10,000 population, counties, metropolitan areas, and states; data on industrial marketing potentials and wholesale trade for states and leading counties.

> *Printers' Ink,* "Advertisers' Guide to Marketing," published annually in October. Provides information summarized from marketing studies, advertising expenditures by major companies and by class of media, operations of advertising agencies, trends in various types of sales promotion as point-of-purchase material, premiums, films, packaging; contains summaries of legal or regulatory developments in the field of marketing.

> *Industrial Marketing,* "Market Data and Directory Number," published annually in June. For each of some 90 industrial markets (e.g., apparel manufacturing, automotive, aviation, baking, etc.) provides information on current trends, what each industry buys, additional sources of information about the industry, current statistics on sales, production, number of plants, geographical distribution of the industry, trade publications and other magazines in each industrial classification.

Advertising Media. Many national magazines, some city newspapers, and radio and television stations publish research studies containing much valuable marketing analysis material. Such studies often contain quantitative information about the size of the market served by the media, qualitative characteristics of the consumer units in the market, their buying power, and

the kind of appeals that can be used to reach them. Special studies are often made to determine buying habits, preferences, or attitudes of consumers. Illustrative are the "Consumer Analysis" studies, published annually by the *Milwaukee Journal* and a number of other newspapers. Information is tabulated on brand preferences of consumers for hundreds of advertised products, the kind of stores in which the consumers purchase each type of product, and the extent of distribution for each product in stores in the community. Some newspapers also publish lists of local retail stores which are arranged in route order, so that they can be used by salesmen in making personal calls. Some national magazines publish their circulation and other market figures by local areas in a manner that is helpful to manufacturers in establishing sales potentials, in delineating salesmen's territories, or in allocating local advertising expenditures.

University Bureaus of Business Research. Bureaus of business research have been established in some 45 universities for the purpose of obtaining and publishing information of value to the business community. Among the better known are those at Harvard, Ohio State, Michigan, Minnesota, Illinois, Indiana, Washington, and Texas. The bureau at Harvard is well known for its studies on the operation of certain types of wholesale and retail institutions, especially its annual reports on the operating results of department stores and limited price variety stores. The bureau at Ohio State has published a number of volumes dealing with various kinds of management problems in several wholesale and retail lines of business. Most of the bureaus have some regular publication which deals with business conditions in general and with sales trends and marketing problems, either nationally or in the state or region principally served by the university.

Marketing Research Companies. Increasing attention to the importance of the marketing research function has led to the development of a large number of institutions that specialize in this activity and do work for regular or occasional clients, usually on a fee basis.[10] Many of these organizations are primarily engaged in conducting surveys and polls of consumer or trade opinion or attitudes. Some of them have a number of branch offices and employ a substantial staff equipped to handle large-scale interviewing surveys in all parts of the country. Certain companies provide a continuing kind of information service available on a subscription basis. Among the kinds of marketing information which can be purchased in this manner are reports of sales by brands of products as ascertained by audits in retail stores; readership of newspaper advertisements in metropolitan papers; and extent of the audience reached by broadcast advertising media. Some agencies are highly

[10] The operations of more than 250 individual marketing research organizations are described in *Bradford's Survey and Directory of Marketing Research Agencies* (New Rochelle, N. Y.: Dr. Ernest S. Bradford, 1956).

specialized in terms of the service rendered, confining their activities to problems of product package design, to market testing, or to the testing of personnel for placement in marketing or selling positions. Other research organizations offer a very wide range of services and have expert marketing consultants capable of setting up a plan for doing research on any kind of a marketing problem and provide the machinery for doing the research work and reporting on it to their clients.

Other Private Sources. A variety of business institutions whose primary business is something other than the supplying of marketing information are nevertheless actively engaged in the performance of this function. As has been explained in earlier parts of this text, marketing information is one of the important services rendered for customers by brokers, selling agents, wholesalers, commodity exchanges, advertising agencies, resident buying offices, and mercantile credit organizations. Other kinds of companies that often make studies pertaining to the market areas they serve are banks, public utilities, railroads, and large motor freight carriers.

Direct Sources of Information. Much information can be obtained from the businessman's own organization. His records, if properly planned and kept, should yield many interesting and valuable facts. They should show any changes that are developing in the relative sales of the different items in stock and should do this in time to permit of all necessary adjustment. The relative efficiency of different salesmen and various methods of sales promotion can be judged to some extent from properly planned records. Cost records should show the relative profitableness of different manufactured or stock items.

The sales force is a fertile source of marketing information. Because of their direct contact with customers, salesmen are in a position to know consumer preferences and to observe changes in demand. The efficient salesmen for a manufacturer or wholesaler should be able to observe and evaluate different merchandising methods and pass on successful plans to the sales manager for his guidance in sales promotional activities.

Many retailers make frequent visits to the principal buying markets and thus are in a position to secure first-hand information of style and other tendencies. This is particularly true in lines which have formal exhibits or fairs such as the "furniture markets" at Grand Rapids and Chicago. The extent to which a merchant may profit from market visits probably depends on how well he knows the merchandise he is buying and how observant he is.

Examples of Marketing Research in Practice

Most businesses find that marketing information from published sources is very helpful but that it does not completely satisfy their requirements.

Even when published information is relevant to a particular marketing problem, considerable effort is often required to combine the data from various sources, apply statistical procedures, and make pertinent analyses. Often, however, a search of available published sources reveals that the kind of data required for an intelligent marketing decision are not available and the individual company must go to considerable trouble or expense in developing suitable information. In either circumstance, the marketing research function is performed by the individual enterprise. In many large companies, this is primarily the responsibility of special marketing research personnel, but whether the company is large or small, various marketing executives or operating employees are engaged in this research function in one way or another.

The kinds of problems that receive attention through research procedures are so exceedingly numerous that they cannot be covered within the scope of a single chapter. The character of research activity and its significance as a facilitating function of marketing may be revealed, however, by a few selected examples.

Forecasting Sales. One of the most significant uses of marketing information is that of estimating future sales. Short-range estimates, involving periods of several months to a year, are essential to retailing and wholesaling companies for determining their requirements for merchandise to be purchased; they are required by manufacturing companies in order to establish production schedules and plans for procuring needed raw materials and other purchased supplies and services. Forecasts covering longer periods, from five to twenty-five years, are utilized to resolve questions relating to plans for expanding physical facilities and for future personnel and capital needs. Different companies develop either type of forecast in a variety of ways, but in most cases the procedures involve use of some combination of data from published external sources and from internal business records.

Determining Optimum Size or Location of Physical Facilities. A problem of special importance to multi-unit organizations is to determine how many establishments should be operated, how large they should be, and how they should be located to serve the market adequately and at minimum cost. Department stores face such problems in decisions relating to horizontal expansion through branch store units. Chain retailing organizations must resolve similar questions when adding new retail store units or in establishing wholesale distribution warehouses. Chain and branch house wholesalers encounter comparable problems when deciding to add new units or to discontinue operation of existing establishments. Manufacturing companies must resolve similar questions when it comes to deciding upon new factory locations, the opening of district sales offices, or the operation of branch wholesale warehouses.

An approach to the problem may be illustrated with reference to a New England firm which served some of its customers by deliveries from its factory and others through a system of branch wholesale warehouses which it operated.[11] A number of wholesale warehouses had been added to the distribution structure one at a time as the volume of business in various market areas increased. This had been done on the basis of common-sense judgments which, it was realized, often proved advantageous from the standpoint of one warehouse but sometimes had adverse effects on the operations of other warehouses in adjoining territories. Consulting analysts were employed to develop an answer to the question, "How large a territory should be served by a warehouse to result in a minimum total cost for warehousing, trucking between plant and warehouses, and delivery from warehouses to customers?" Detailed analyses were made of all items of operating expense in the plant and in the warehouses, and it was found that the cost of handling merchandise in each of the warehouses was related to two opposing factors: (1) the volume of business handled in the warehouse and (2) the size of the area served by it. A mathematical model of optimum cost operations for branch warehouses was then constructed. While these procedures are relatively complicated, the purpose is simply to classify variable costs according to their behavior, with respect to volume of business and size of area served, and to determine whether the amount of business gained or lost by increasing or decreasing the size of the warehouse territory by small increments would or would not offset conflicting tendencies in the cost of serving a larger or smaller territory. As a result of such an analysis applied to all of the company's warehouse territories, it was learned that most of the existing warehouses were too large and that costs could be reduced by serving customers through a larger number of smaller warehouses.

A different type of approach to a similar problem is provided by a chain supermarket organization. Through an elaborate study of the shopping habits of urban-area housewives, it was learned, among other things, that distance is not an important factor in discouraging patronage by its customers within the range of about three miles from a store location; beyond this range, however, it becomes an important deterrent. As a consequence, the company attempts to blanket a metropolitan area with supermarkets located approximately six miles apart, so that no customers are more than about three miles from the nearest unit and its stores are not so close together that they compete excessively with each other.

[11] For a complete discussion of this case and an explanation of mathematical procedures relevant to this type of problem, see Edward H. Bowman and John B. Stewart, "Model for Scale of Operations," *The Journal of Marketing,* January, 1956, pp. 242–47.

Determining Current Purchases by Ultimate Consumers. Manufacturers of consumer goods, especially those who use a relatively long channel of distribution, have an urgent need for current marketing information showing the volume of purchases by ultimate consumers. When such a manufacturer sells through wholesalers or chain store warehouses that distribute his goods to retail stores, factory shipments during a given period of time are often a poor indication of consumer purchases. Wholesale establishments and retail stores in the channel may carry inventories of some items varying from a one- or two-week supply to as much as a six- to twelve-month supply. Inventories on one or both levels may fluctuate widely from one month to another; as a consequence, factory sales may be at substantial variance from consumer purchases. Still, information on consumer purchases is vital if the manufacturer is to appraise intelligently the effect of his own or competitive promotional activity, the influence of seasonal factors upon consumer buying, or the presence or lack of speculative buying activity by institutions in the channel.

Several methods are used to measure sales at the retail level, including (1) retail store audits of purchases and inventories; (2) purchase diary records maintained by samples of typical consumers; and, (3) analysis of warranty cards mailed in by consumers making purchases. Two of these methods are illustrated in the following paragraphs.

Store Audit Procedure to Evaluate Promotional Strategy. Marketing information from store audits is a service usually purchased from marketing research organizations. Several companies supply this type of service, the best known one being the A. C. Nielsen Co. This company serves over 200 prominent clients by employing about 175 field representatives who make audits of merchandise movements in a representative sample of about 2,350 food and drug stores in all areas of the United States.[12] Through the cooperation of retailers, field representatives record the beginning inventory each month for each audited item, add all purchases during the month, and subtract the ending inventory, to derive sales to consumers during the month. As a result, the company is able to supply each client with a monthly report that reveals (1) unit sales of its own brand by type of outlet and by region of the country, (2) unit sales for each major competitive brand, and (3) the client's sales expressed as a per cent of total market sales for the type of item.

An extremely important application is that of evaluating the effect of consumer advertising activity. An illustration is provided by a large company that made a drastic modification in its advertising strategy which involved important changes in the quantity and type of advertising as well as in advertising media. During the four months following the change, factory

[12] "New Sales Survey Aims to Catch All the Outlets," *Business Week,* June 18, 1955, pp. 132, 133.

sales of this product declined 19 per cent from the preceding period, which led the advertiser to conclude that the change in strategy was ineffective or had been damaging. Through the store audit reports, a quite different conclusion was reached. This research information revealed that retailers' stocks of the item were high at the beginning of the promotional campaign and had been undergoing substantial liquidation during the four-month period. Moreover, during this period total market sales of all brands declined by 12 per cent. A comparison of the company's sales in relation to total market sales revealed that the company had actually increased *its share* of total consumer sales from 37 per cent at the beginning of the period to 43 per cent at the end of the four-month period. Through research, it was revealed that a move which would have been judged a failure from the standpoint of factory sales had actually been very successful.[13]

Warranty Card Analysis. Store audit procedures are widely used in the case of convenience goods but have not been widely applied to shopping or specialty goods where sales are much more infrequent at the retail level or involve significant seasonal variations. To determine the movement of such commodities to consumers, manufacturers of many forms of major appliances make detailed statistical analyses of warranty cards. Such cards are usually given to the consumer at the time the product is delivered or installed, and must be filled out and mailed to the manufacturer in order to register the beginning of the warranty period. Customers must furnish their name and address, model and serial number of the unit, place of purchase, date of delivery or installation, and, often, other information of marketing significance.

To illustrate the use of warranty cards in marketing research, the case of a leading manufacturer of air conditioning units (Carrier Corporation) may be cited. Marketing research personnel undertook elaborate statistical studies, taking approximately one year, to develop records that reveal the proportion of total retail sales for which warranty cards are ordinarily returned within a period of one week. Experience with this company's product revealed that 70 per cent of the cards that eventually come back are received within this period of time.[14] From this information it is possible to estimate sales by weeks. As a first step, cards received during each week are sorted according to the date of delivery or installation. If, for example, 2,100 cards were received that indicated an installation during the preceding week, estimated sales for that week would be 3,000 units (2,100 divided by .70). Such information is especially important to the manufacturer of a seasonal item, where large stocks must be supplied to

[13] Arthur C. Nielsen, "Evolution of Factual Techniques in Marketing Research" (Chicago: The A. C. Nielsen Co., 1952), pp. 24–25.

[14] Lee Gunlogson and John Neter, "Warranty Card Analysis to Estimate Retail Sales," *Journal of Marketing*, July, 1954, p. 31.

the distribution channel in advance of the peak selling period. Through this type of analysis, the manufacturer knows the rate of consumer sales from week to week and can judge whether consumer sales are up to expectations and, consequently, whether to maintain production at expected levels or to increase or curtail manufacturing activity, revise prices, or enter into different types of promotional activity.

Obtaining Marketing Information from the Consumer. It often happens that the marketing information needed to solve a particular problem cannot be obtained from published sources, cannot be developed from analyses of a firm's internal records, and cannot be supplied by agencies in the channel of distribution. In such cases, it is often necessary to resort to surveys of consumer opinion. Various applications of the findings of consumer research have been discussed in Chapter 4, in connection with the study of consumer motivation. Little attention was given, however, to the complexity of planning and administering a comprehensive consumer survey.

An operational chart indicating the sequence of activities in a well-planned consumer investigation is provided in Figure 8.[15] Such an investigation begins with a statement of the marketing organization's problem, which may be of the form, "What can we do to increase the share of the market now enjoyed by our frozen orange juice?" Through discussions with the client, the research organization attempts to obtain pertinent data on the product, its position in the market, and the client's aims and philosophy of doing business. This is ordinarily supplemented by information from available research studies on related problems and a study of the position of competitive products in the markets.

After a review of such information, research personnel develops ideas or hunches by observations of their own behavior or attitudes in relation to the problem at hand, perhaps by inquiring why they do or do not like or use orange juice or the particular client's brand of orange juice. On the basis of such hunches, information is obtained about other people's behavior or motivations. This may be done by conducting long and detailed interviews with a variety of consumers to ascertain their feelings, by using various kinds of direct or projective techniques developed in psychology or psychiatry to test consumer reactions to ideas relevant to the investigation, or by employing some form of statistically sound surveys to ascertain the relative significance of different buying motives.

From the information gleaned from such preliminary study, the researchers can proceed to develop the experimental design for a complete investigation of the problem. This usually involves the formulation of some hypotheses, of the following illustrative character: "Consumers would like

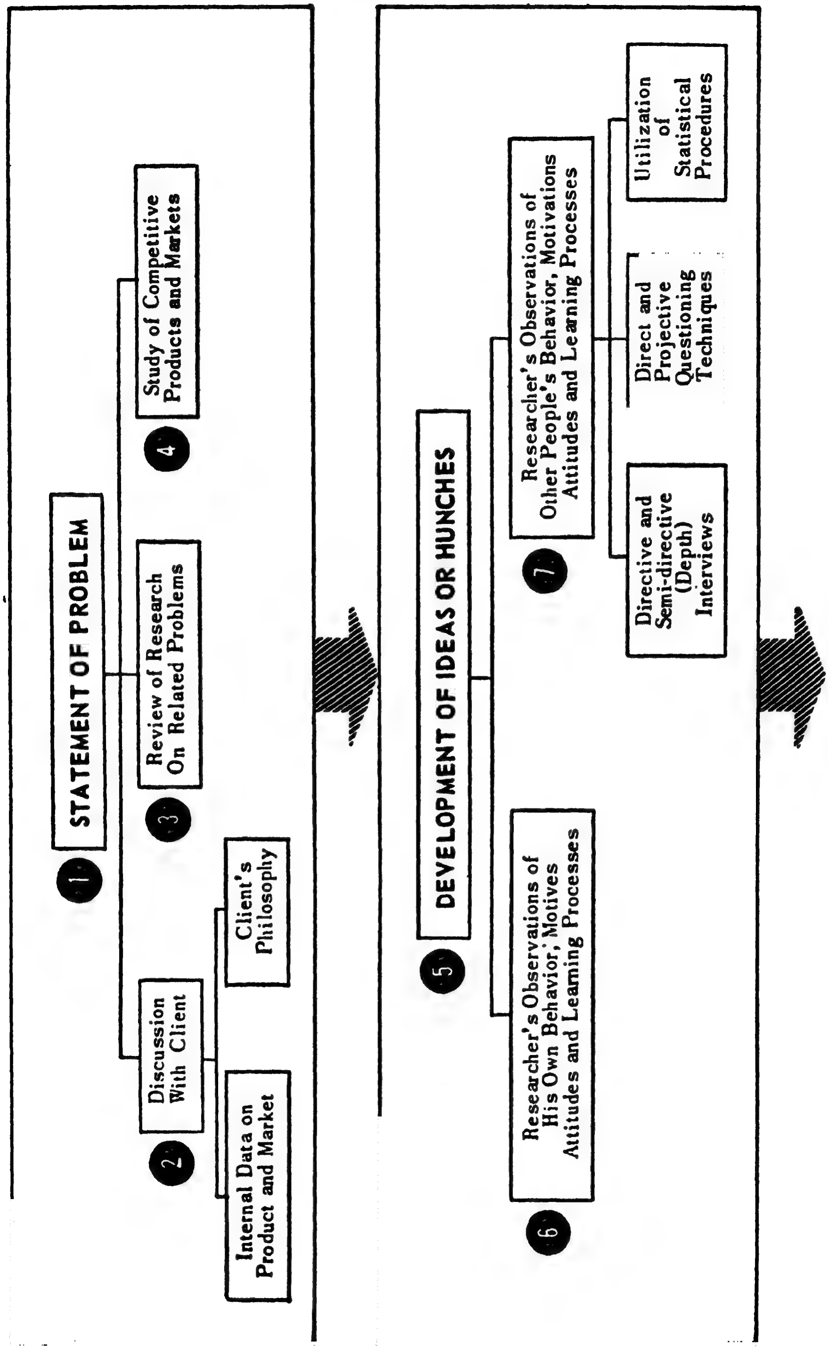
[15] The authors are indebted to Alfred Politz Research, Inc., for permission to draw upon material published by that company for this discussion.

to buy frozen orange juice in larger cans." It is then necessary to determine just what types of analyses are required in order to confirm or refute such hypotheses, to determine interviewing and sampling procedures, and to formulate the pattern of tabulations for the data to be collected.

At this point, the research organization is ready to undertake a field survey. A questionnaire is developed and usually pretested on a small group of consumers to determine whether the wording is clear and whether the questions are understood by respondents as intended by the research objectives. Decisions must be made about the type of sample to be surveyed, including such matters as the number of respondents, kind of respondents (e.g., only housewives), how the sample is to be distributed geographically, and when consumers are to be reached (season of year, day of week, time of day). Interviewers must then be obtained and instructed in their work. When the questionnaires are completed by the interviewing staff, they are edited for legibility and meaning and the responses are grouped into categories for coding and tabulation.

When tabulations are completed, researchers analyze the data to ascertain their meaning in relation to the hypotheses. After interpretation of the results, specific conclusions are formulated in terms of various courses of action that might be taken by the client. Recommendations are statements of the course of action that the research organization thinks the client should take and the results that are to be expected if such courses of action are followed. From the foregoing, it is apparent that consumer research is a complicated undertaking. It is not the mere collection and analysis of facts, but it involves also the attempt to predict the results of a recommended course of action.

Conclusion. Like all the other marketing functions, that involving marketing information and research is important, inherent in the nature of marketing, pervasive throughout the field, and is evidenced by a considerable degree of specialization of human activity devoted to its performance. While marketing information of some kind or other has been gathered and disseminated so long as exchange has been important, the application of scientific research methods to particular marketing problems is a rather modern development, one which came into prominence in the years following World War I, and which has been greatly accelerated and refined in the period subsequent to World War II. Examples in this chapter have indicated the manner in which marketing information and research facilitate the performance of all the other marketing functions. Not only is marketing information facilitating in this respect, but it adds immeasurably to the efficiency with which manufacturing and agricultural resources are utilized as well. As stated by the marketing research staff of one of the nation's most prominent industrial corporations, "Successful manufacturing rests


1
STATEMENT OF PROBLEM
2
Discussion With Client
Internal Data on Product and Market
Client's Philosophy
3
Review of Research On Related Problems
4
Study of Competitive Products and Markets
5
DEVELOPMENT OF IDEAS OR HUNCHES
6
Researcher's Observations of His Own Behavior, Motives Attitudes and Learning Processes
7
Researcher's Observations of Other People's Behavior, Motivations Attitudes and Learning Processes
Directive and Semi-directive (Depth) Interviews
Direct and Projective Questioning Techniques
Utilization of Statistical Procedures

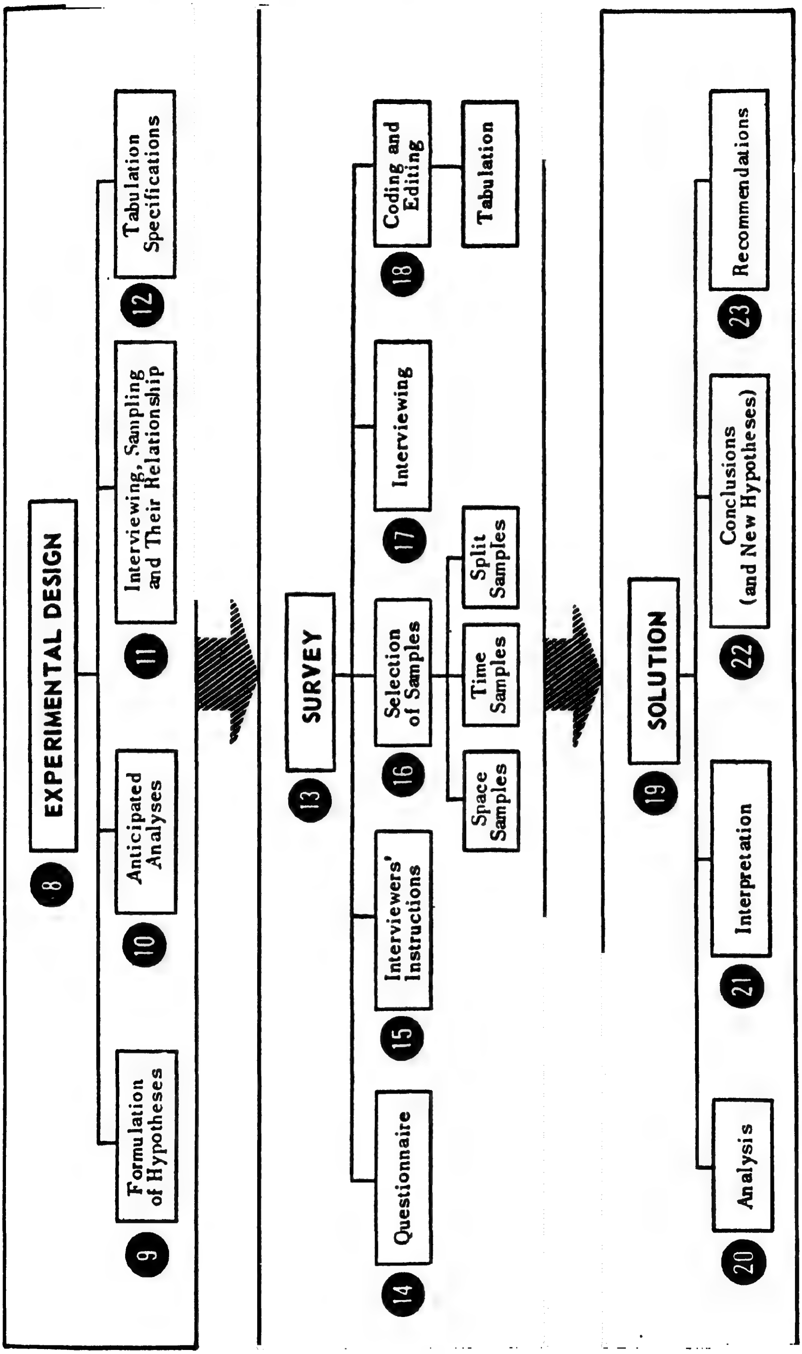


FIG. 8. Operational chart for consumer research (prepared by Alfred Politz Research, Inc., New York and previously published in *Tide* magazine; reproduced by permission).

upon a knowledge of natural laws on the one hand, and *a knowledge of human needs on the other* hand. . . . On the basis of such knowledge and through the application of engineering skill and manufacturing technique, raw materials are transformed into useful products."[16]

QUESTIONS AND PROBLEMS

1. Briefly define or explain the meaning of each of the following terms:
   a) marketing research
   b) census
   c) store audit
   d) warranty card analysis
2. Is there any connection or relationship between marketing research and marketing principles? Explain.
3. Is the further application of a research approach limited by the fact that businessmen cannot obtain information which is relevant to marketing problems? Explain.
4. Does marketing research eliminate the need for judgment in marketing decisions? Explain.
5. Why is the government more actively concerned with the performance of the function of collecting and disseminating marketing information than it is with the performance of the other seven marketing functions? How can the expenditure of government funds be justified for this purpose? Should not individual business firms collect their own marketing information? Explain.
6. What are the various major Censuses that are of interest for marketing research purposes? Give several illustrations of typical uses for the information found in each of these Censuses.
7. If the government spends millions of dollars to conduct major Censuses at periodic intervals of five to ten years, why does it also go to the expense of providing current (monthly or quarterly) reports along the same lines as covered in the Censuses? Explain.
8. The U. S. Department of Agriculture spends millions of dollars annually to collect and disseminate information pertaining to the marketing of agricultural commodities. Is this not an unfair subsidization of the farmer at the expense of other taxpayers? Explain.
9. If a large number of agencies (including government, trade associations, advertising media, marketing research companies, bureaus of business research, etc.) publish such a vast quantity of marketing information, why is it also necessary for so many manufacturing and merchandising organizations to engage in marketing research activity? Explain.
10. A very large independent store, which is located in one of the nation's five largest metropolitan areas, opened a substantial department store branch in the suburban area about two years ago. This branch store has been successful from the start, and a decision has been made to open two or

[16] *Is It Scientific?* (Detroit: Customer Research Staff, General Motors Corporation, undated), p. 5 (emphasis supplied).

three additional branches in other parts of the suburban area during the next several years. Store executives are wondering just how far consumers will travel from their homes to visit such a store, and would like to develop some positive information about the size of a trading area that can be served by it, in order to decide about how far apart branches should be located in the future. What kinds of internal information would be available for this kind of analysis? Explain how such information can be used for this purpose.

11. A manufacturer of a line of adding machines, bookkeeping machines, and automatic calculators is in the process of establishing sales quotas. What factors should this company consider in establishing the quotas? Where can information be obtained which will enable it to consider and weigh properly each of these factors?

12. A variety chain is considering the possibilities of opening a unit in your home town. It is interested in knowing the population of the city, the population of the trading area, the number and types of industries, and the number and types of existing retail outlets. What are the sources for this information? Collect the required information for your home town and present it in the form of a two- or three-page report.

13. A large manufacturer of electric sewing machines is considering the development of two new sales areas of about equal population and equal geographic size. One of the areas is predominantly industrial and the other is predominantly agricultural in character. The machines sell for about $115 each. What factors will determine the relative sales in each area, and where may you obtain the information pertinent to this problem?

14. List the current trade journals and other such publications in your library which are valuable sources of market information.

VI

SOME IMPORTANT MARKETING POLICIES

30

PRODUCT AND BRAND POLICIES

Ultimate success or failure of any marketing organization is to a large extent dependent upon the policies that are formulated and administered. Unless a business operates with the benefit of a sound policy program, it meanders aimlessly, without proper guides to the attainment of objectives.

Purpose of Marketing Policies. *Policies constitute definite courses of action predetermined for the purpose of securing uniformity of procedure so long as substantially similar conditions exist.* If based upon definite and accurate knowledge, they provide guidance for the solution of *recurring* problems.

Marketing policies may be major or minor, depending primarily upon the formulating or determining authority. A major policy is one that is established by top or general management of the business, while a minor policy is determined and set by the head of a given department or division of the business with respect to his immediate operations. Whether to handle private brands is usually determined by top management and is therefore a major policy. A policy concerning the sources from which to buy merchandise for private branding and in what quantity is usually determined by the buyer in charge and hence is a minor policy. It is thus possible for a given marketing policy to be considered major in one enterprise and minor in another.

Advantages of Policies. Marketing policies may be justified by reason of three common advantages. One is that the time of executives is saved. After a general guiding rule is adopted, executives do not have to give individual attention to similar situations but make decisions based upon the policy. Second, policies insure uniformity of action. Customers, suppliers,

employees, or others affected by policies are given equal treatment under similar circumstances. Third, policies are usually adopted only after careful consideration of all factors involved. Decisions are carefully deliberated, thus minimizing temporary and personal considerations which often influence action.

Nature of Some Specific Marketing Policies. When both major and minor marketing policies are considered, their number is very large. Because they relate to all marketing activities, many of them have been discussed at appropriate points in earlier chapters that dealt with retailing and wholesaling institutions and with marketing functions. The present part which deals specifically with policies is only five chapters in length. This brief treatment should not, therefore, be taken as an index of the full importance of sound policy formulation. Because certain policy matters have been discussed throughout the book, this part is devoted only to a more detailed treatment of a limited number of extremely important policy questions that can best be handled in this manner.

Product Policies

In a competitive private enterprise economy, the men who prosper most are those who succeed in satisfying the wants of people in the best possible and cheapest way. In general, the profit system tends to reward those who do the best job of offering products or services which most adequately or most economically satisfy the most urgent of the previously ungratified wants of sovereign consumers who, by the distribution of their current consumption expenditures among a wide range of available free choices, guide the future ownership and control of the means of production.

Character of Product Policies. Product policies serve as guides in determining what classes of products or what specific items shall be manufactured or handled for resale, and what the specific characteristics of these items shall be. The task of planning the composition of a product line and adjusting it to the ever-changing pattern of consumer demand is often referred to as *merchandising,* especially in large manufacturing, wholesaling, and retailing companies. Since the so-called merchandising activities of retail and wholesale middlemen have been indicated in earlier parts of this text, the treatment of product policies in this section is approached primarily from the point of view of the manufacturer.

Among large manufacturing companies, such policies are one of the most significant responsibilities in the work of the top management executives. These persons are commonly assisted in policy formulation by staff officials who devote their attention to the job of product development and product planning. *Product development* embraces the work of technical research

and engineering design; *product planning,* on the other hand, is concerned with estimates of the magnitude of potential markets, estimates of sales volume, budgeting of costs, and other matters relating to the economics of modifying a product line.

Successfully managed companies have found it advisable to formulate definite policies to spell out the conditions under which new products should be taken on, existing products modified, or some products discontinued. Product policy is also concerned with a variety of additional matters including quality, design, exploitation of new uses for existing products, improvements in packaging, and branding.

Motives for New Product Development. New products are added to those already manufactured or handled for resale principally because of short-run or long-run profit considerations. A number of more specific classes of motives may, however, be identified and are helpful in explaining the great importance of product policies.

First, new product developments are almost always an instrument of *growth.* The rate of expansion possible with a restricted or fixed product line is, of course, always more limited than is the case when altogether new opportunities are available from time to time. Rapid growth through product diversification and expansion has, for example, been a major part of the development of the principal companies in the chemical and electrical industries.

Second, many companies find it necessary to add to or improve their product line merely in order to *maintain* their *competitive position.* This is especially important in the apparel trades, where all companies in a given industry must quickly adapt to changes in the popularity of general and specific fashions or suffer drastic consequences. It is also of exceptional import in the field of consumer durable goods where competitive product improvements or innovations are introduced with frequency or regularity.

Third, many product changes are forced by *changes in related industries.* The petroleum refining and automobile manufacturing industries constitute an outstanding example of close interrelationships in product developments. Increases in the compression ratios of newer models of automotive engines necessitate higher octane motor fuels. Thus the ability of the automotive industry to market automobiles with more powerful engines is limited, in part, by the ability of the petroleum industry to supply the required fuels. Competition within the petroleum industry is so intense, however, that each major refiner attempts to take the lead in supplying grades or qualities of motor fuels that meet the requirements of the most advanced automotive power plants.

Fourth, *diversification of risks* by serving different needs or markets is often a motivating circumstance. To illustrate, the Bell & Howell Company

which originally specialized in motion picture cameras and projectors found that it was vulnerable to business fluctuations. Business was stabilized and risks more widely distributed by expanding into the field of microfilming, tape recording, and high-fidelity phonograph equipment.

A fifth factor is the desire *to offset sales in declining markets.* For example, expenditures for men's suits and topcoats have been declining in relation to total consumer expenditures over the years following the middle 1940's. This has led many major manufacturers in this industry to bring out new products in the leisure apparel or sports apparel market (e.g., sport coats, jackets, sport shirts, slacks, shorts) in which consumer expenditures have been rising at a much more favorable rate.

A desire to achieve *temporal stability* is another important consideration. To illustrate, at one time the sales pattern of the McGraw Electric Company, manufacturer of Toastmaster and other electrical appliances, experienced undesirable seasonal peaks and valleys and was unfavorably influenced by cyclical factors. This was offset by a long-range planned program of expansion which involved the manufacture of transformers, transmission equipment, circuit breakers, and other items marketed to public utility companies. By entering the industrial market, the company achieved greater temporal stability, both seasonal and cyclical.

Criteria of Product Acceptability. After a new product has been decided upon by a manufacturing company, much expense is incurred over a considerable period of time for field surveys of consumer demand, estimates of competitive activity and potential markets, preliminary and final design specifications, engineering and marketing tests, and design and marketing plan modifications, all of which are commonly done prior to final production and marketing on a substantial scale. The success of a new product cannot be judged entirely by the volume of initial purchases by consumers or users. The ultimate test is whether initial purchasers are willing to make repeat purchases. Consequently, it usually takes as much as six months and often as much as two or three years before the success of a product innovation can be judged properly. Of the many thousands of new products that are introduced annually, only a small percentage is successful. Consequently, it is understandable why most companies approach the introduction of new products with great caution, evaluating new ideas in the light of various criteria, the most important of which are discussed below.

Marginal Cost and Revenue Approach. From the standpoint of economic analysis, a firm is better off by adding a new product only when the expected revenue from the sale of that product will exceed the amount of cost incurred in doing so. Such expectations are usually most favorable when there are certain fixed costs which can be shared by all products, old and new. When any kind of fixed cost can be spread over a wider sales volume base, it

may be said that previously some "excess capacity" existed. This is true in the sense that it would cost the company less to manufacture and market the new product than it would cost some other firms that might be set up to do so alone. Excess capacity may exist in a number of ways. These may involve the incomplete utilization of managerial skills, manufacturing facilities, distributive facilities, advertising, or financial resources. It is, however, rather difficult to formulate accurate estimates of probable revenue from the sale of a new product, especially in view of the fact that competitive activity is likely to be increased as a result of the introduction of a new product into the field. Thus, probable marginal revenue can only be approximated. Elaborate budgets are likely to be prepared only if the new product meets certain other indicated common-sense standards of acceptability.

Distinctive Know-How. Sometimes a main factor in determining the acceptability of a new product is that it requires or can benefit considerably from the distinctive "know-how" that constitutes a company's differential advantage within its industry. This criterion may be illustrated with reference to the Clevite Corporation, which has a number of major divisions in the industrial markets for bronze bushings, bearings, technical instruments, transistors, and other electronic products. The principle which guides policy on new products has been described by the company president as follows: "In a 'component' business like ours, we try to select products that will enable us to use fully the specialized technological, engineering, and manufacturing skills that we have and that are not readily available to competitors."[1]

Full-Line Marketing. When a company has a full line of products, relative to the number of related products successfully marketed by its more important rivals, it has substantial advantages in terms of advertising impact, personal selling costs, economies in physical distribution, and ability to obtain and maintain a superior organization of wholesale and retail outlets in its channels of distribution. Such considerations have prompted a number of mergers and consolidations within the major appliance industry since 1946. Manufacturers of only one or a few appliances have found it increasingly difficult to compete with others who sell a wide range of such products. Certain specialized manufacturers have discontinued business, while others have sold their facilities to other manufacturers who were in the process of developing a complete line. As one example, late in 1956, the Avco Manufacturing Corporation discontinued its Crosley line of major appliances, which had proved unprofitable, and sold its Bendix line of home laundry equipment to Philco Corporation. The acquisition of the Bendix product line gave Philco a relatively full line of major appliances, rivaling that of General Electric and Westinghouse.

[1] William G. Laffer, as quoted in *Fortune*, September, 1955, p. 95.

Substantial economies in physical distribution functions are achieved by full-line marketing organizations that can move "mixed" or "pool" car shipments under common freight classifications, thus obtaining the benefit of minimum freight shipment costs. In the paper industry, for example, there are a number of manufacturers of a diverse line of wrapping papers, meat packaging materials, egg cartons, towels, napkins, cups, plates, ice cream containers, etc. Even though individual products in the line may usually be sold in small volume and could be shipped ordinarily only at l.c.l. rates, wholesalers and large industrial users can consolidate their requirements and purchase a mixture of such items in carload quantities, thereby obtaining maximum transportation economies.

Common Channel of Distribution. Ability to utilize the facilities of a sales organization more fully often explains attempts to market additional products which can be moved through the same channel of distribution. In part this is related to the examples cited above, but may be considered as a separate point in that distinctive know-how or product-line relationship need not be involved. So long as the new product is sold to the same class of buyers and can be handled by the same marketing organization, it is more acceptable than when new marketing institutions must be sought out for it. A new product requiring marketing effort through a new or strange channel is rarely introduced by a company unless it can be done upon such a large and promising scale that a separate sales organization can be economically developed solely for the marketing of such product.

Manufacturing Considerations. While marketing factors tend to dominate policies related to new product development, the most desirable avenues of approach are frequently indicated by manufacturing considerations. Sometimes this means that an acceptable new product is one for which existing manufacturing or processing facilities can be used. Thus, an Ohio manufacturer of wooden gift boxes of the kind used for sets of silverware entered the field of small occasional tables. As a result of declining sales trends in wooden gift boxes, there was idle manufacturing capacity. Small tables could be made with the same type of raw material and by utilizing manufacturing equipment already installed and in operation. The new product also helped to iron out seasonal peaks and valleys in production previously experienced.

Some companies look for new products that can be manufactured from the same types of materials or from by-products. Most of the major meat packing companies have become important manufacturers and marketers of pharmaceutical products, which have been developed out of research to utilize all possible by-products of the meat manufacturing process. The idea of making new products with common raw material ingredients is most

prevalent among vertically integrated companies that control raw material sources, that can profit from an expansion in the market for such a basic raw material, or that can exploit fully the differential between basic material cost and price of finished product made from it. This has been especially common within the petroleum refining, rubber, and chemical industries.

Acquiring New Products by Merger: Legal Limitations. One approach to product diversification or expansion is research, development, and marketing planning within the company. Another approach, especially popular in recent years, has been the acquisition of products by purchase of other companies with well-established products. Of some 2,000 corporate mergers and acquisitions taking place between 1951 and 1954, about 25 per cent, according to the Federal Trade Commission, were for purchases of product-line diversification. The Warner-Lambert Pharmaceutical Co., for example, was formed in 1956 as a result of the merger of the Lambert Pharmaceutical Co., manufacturers of Listerine Products, and the William R. Warner Co., a leading toilet goods and cosmetics manufacturer. The Gillette Co., formerly a specialized manufacturer of razors and razor blades, diversified by acquiring the Toni line of home permanents and the Paper Mate line of pens. The Elgin National Watch Co. expanded into the field of miniature electronics and precision instruments by purchasing Neomatic Inc., American Microphone Company, and Advance Electric & Relay Co.

When there is a close relationship between the products marketed by the two companies involved in a merger, there is a possibility that the acquisition of the one by the other may be in violation of the federal Clayton Act which, as amended in 1950, provides that:

> No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly.

This law, which is enforced both by the U. S. Department of Justice and the Federal Trade Commission, requires findings and conclusions not of *actual* anticompetitive effects, but *merely* of a *reasonable probability* of a substantial lessening of competition or tendency toward monopoly. As explained in the House of Representatives report on this legislation, such an effect may arise in various ways, including the "elimination in whole or in material part of the competitive activity of an enterprise which has been a substantial factor in competition, increase in the relative size of the enterprise making the acquisition to such a point that its advantage over its competitors threatens to be decisive, undue reduction in the number of com-

peting enterprises, or establishment of relationships between buyers and sellers which deprive their rivals of a fair opportunity to compete."[2]

Whether the Clayton Act has or has not been violated in the case of a specific merger or consolidation depends not upon any absolute rule or generalization, but upon findings of fact and interpretations in the light of specific situations. An illustration of the type of merger alleged by the Federal Trade Commission to be a prima-facie violation of Section 7 of The Clayton Act is provided by the case of Pillsbury Mills, Inc.[3] In 1951 and 1952, Pillsbury acquired the assets of two of its principal competitors, namely, Ballard and Ballard Company and Duff's Baking Mix Division of American Home Products Corporation. The companies acquired by Pillsbury had been in substantial competition with it prior to the acquisition. As a consequence of the merger, Pillsbury's share of the market in the southeastern part of the United States increased substantially. For bakery flour, its sales in this region increased by 40 per cent; for mixes, by 78 per cent; for family flour, by 154 per cent; and for feed, by 775 per cent. These changes occurred in an industry in which the number of mills had been declining and a larger per cent of industry sales was being realized by a steadily declining number of companies.

Modifications of Existing Products. There appears to be no uniform rule governing the number of items that can be marketed by any one organization. The Coca Cola Company has long been successful as a marketer of a single product, although sold or packaged in a number of variations. The H. J. Heinz Company in the food field and the Eli Lilly and Co. in the drug trade are well-known companies with relatively long lines of products, but in both cases the products are closely related in terms of final use and channel of distribution through which they are marketed. Other companies such as Avco Manufacturing Corporation have provided a wide range of products and services without any close or discernible relationship among many of them. Regardless of the number of items in a company's line, or its policies regarding the contraction or expansion of its line, it is faced with continuing questions relating to modifications of its existing products. In the competitive struggle to maximize sales volume and profits by providing products which will better satisfy consumer wants and desires, modifications of both consumer and industrial products are almost continuous.

Forms of Product Modification. Modifications of existing products take a wide variety of specific forms. *Style change which creates fashion obsolescence* is a popular form of modification—one often cited by critics of

[2] H. R. 1191, 81st Cong., as quoted in *Report of the Attorney General's National Committee to Study the Antitrust Laws* (Washington, D. C.: Government Printing Office, 1955), p. 118.

[3] F.T.C. Docket 6000 (1953). Still pending at end of 1956.

our marketing system as a source of waste and dissatisfaction, but one which is credited by proponents of private competitive enterprise as the major explanation of our high levels of employment, family income, and living standards. Planned obsolescence of pre-existing models is the basis for many product changes in durable and nondurable goods, as illustrated by certain aspects of annual model changes in automobiles and fashion changes from season to season, and even within seasons, in ready-to-wear apparel.

Certain *design changes* are primarily *related to utility* rather than to fashion obsolescence. Automatic washing machines with lint filtering features were a popularly accepted modification in 1956 because such features solved a problem which was a common source of consumer dissatisfaction. Many features in automotive design are related to utility as well as fashion as in the case, for example, of automatic transmissions, turn signal indicators, factory installed air-conditioning, power steering, and power brakes.

Changes in the types of *materials* used in manufacture is another form of modification. In order to reach wider markets, manufacturers of television sets used mass-produced plastic cabinets because these were much more economical than the wood cabinets which were used almost exclusively in the models first manufactured by the industry. New ingredients used in peanut butter and certain cheese products have made it easier to spread them on bread or crackers. The use of foam rubber in upholstered furniture has had an important influence upon the quality, appearance, and cost of many items in this category.

Perhaps the most common product modification in marketing convenience goods consists of changes in *packaging*. Traditionally, the functions of packages have been to provide a measure of a standard unit of sale and to preserve or protect the product until time of final use. Under modern conditions, as a result of the influence of self-service merchandising techniques, the package must also clearly identify the product to the consumer and serve as a "silent salesman." In addition, many packages are designed to enhance the utility of the product after purchase, by measuring it or dispensing it in some form. Illustrative of important innovations in this category in recent years have been the aerosol containers used for a number of products such as insecticides and shaving cream and polyethylene "squeeze bottles" introduced in connection with Stopette deodorant but now used for many liquid and powder products, chiefly in the cosmetic and toilet goods industries.

Management Problems in Introducing Modifications. The introduction of modifications to existing products poses a number of complicated management problems which can be but briefly suggested in this general treatment of marketing. Unless modifications are regular and expected by the trade, as in the case of annual model changes for automobiles and certain major ap-

pliances, the timing of the introduction is a major problem. Although modifications are sometimes used as a device to offset a declining or depressed sales situation, it is generally regarded as preferable to plan for the introduction of modifications at times when cyclical or seasonal factors indicate that the market will be highly responsive. Plans must be laid sufficiently in advance so that wholesalers and dealers are notified and are not caught with large inventories which will become obsolete. Arrangements must be made for personal selling and for physical distribution in advance of widespread consumer advertising and sales promotional activities. Problems of physical distribution are often very great. If a new model or new packaging is to be introduced through advertising on a given date, all wholesalers and all retailers handling the product must be supplied with a normal stock quantity almost simultaneously. Such a requirement places a heavy strain upon physical facilities of the manufacturer and his warehousing and shipping organization and calls for the most careful advance planning. The introduction of significant product modifications is normally accompanied by unusual amounts of advertising and sales promotion efforts which must be carefully planned and integrated with other plans for personal selling and physical distribution.

Brand Policies

One of the most distinctive features of modern marketing is the wide use of brands by manufacturers and distributors and the general acceptance of or preference for branded items upon the part of most consumers. At this point, certain purposes and methods of demand creation and some of the problems connected with the sale of branded merchandise are considered.

Reasons for Brands. One of the principal reasons for the use of a brand name is that it helps the purchaser to identify the article which he is buying. While identification is sometimes accomplished by other means, such as trademarks or unusual containers, brand names are the principal instruments.

Second, in addition to identification, brands actually protect the buyer. As long as a consumer or other buyer continues to purchase branded articles, the manufacturer of which is known, he is protected as to standards of quality and to some extent in the matter of price. At least he knows what he has been paying for the article and can form a judgment as to a fair price in a strange purchasing situation.

Third, brands protect their owners by giving them a certain measure of control over the demand for the products. It is frequently the goal of a manufacturer of a branded article to make his product superior at a given price and so well known that thousands or millions of consumers and other buyers will insist on that brand or at least prefer it to others. Many manufacturers

and wholesalers have gained consumer preference for their brands, but probably the majority have only succeeded in securing consumer acceptance.

A fourth reason is that a brand name is a necessary adjunct to any form of demand-creation activity in which appeals to selective rather than to primary buying motives are stressed. Thus, selective or competitive selling effort and brands are mutually interdependent.

Fifth, the use of a brand name enables a manufacturer to add different products to his lines, for it facilitates the introduction of new items in consequence of the prestige derived from his existing brand.

Finally, in the case of technical products of high unit value, a brand name is of aid in stressing repairs or other consumer services. Prospective buyers of automobiles, adding machines, typewriters, cash registers, and other such devices are much more inclined to buy a particular item if they know that they can secure certain types of repair service at convenient places and at moderate charges. Companies which have stressed this service, such as the Burroughs Corporation, have found that it helps not only to create a general demand for calculating and accounting machines but also to center the demand on their particular make or brand of office equipment. Manufacturers of articles of this kind could hardly be expected to render service on unbranded articles, for the good will incident to such service would not be reflected in additional demand for like articles, that is, for a particular brand.

Types of Brands. An examination of the different brands on the market discloses several distinct types. First there are brands adopted and sponsored by manufacturers, and commonly known either as "manufacturers'" or "national" brands. The latter designation tends to emphasize the fact that the most successful brands that have been adopted by manufacturers and pushed aggressively have been generally advertised on a national scale, although many manufacturers' brands are known only in certain districts.[4]

Second, there is an increasing number of brands placed on the market under the auspices of wholesale middlemen. Such brands are generally referred to as "private brands." Some of these brands are nationally advertised, but generally speaking, they are more or less locally known. Similarly, a number of retailers, particularly among the larger institutions such as department stores, mail order houses, and chain stores, have followed a like policy, selling large quantities of merchandise under their own label. These brands are commonly designated as "retailers' private brands." Finally, the years beginning with the 1930's have given rise to considerable group buying and to the formation of many associations of wholesalers and retailers, respectively. One purpose of such associations is to adopt and develop a common trademark to be applied to certain types of merchandise purchased for the

[4] Hundreds of branded articles, especially in the industrial field, are not advertised to any extent; but the brands serve to make it possible for users of these commodities to reorder the articles which have proved satisfactory.

group collectively. These brands usually enjoy greater prestige than private brands of single members of the group and can be advertised on a much wider scale, with regard to both expense and territory. The development of all these private brands has given rise to considerable controversy and ill feeling on the part of manufacturers and has resulted in some intricate marketing problems extremely difficult of solution. Some of these aspects will be treated in the following pages.

It is believed that a more useful classification of brands is one which divides them into *manufacturers'* brands and *distributors'* or so-called *private* brands. The terms "national" versus "private" brands have long since lost their special meaning. Many distributors' brands are now nationally advertised and sold, while the number of manufacturers' brands locally distributed and nationally unknown is legion.

Manufacturers' Brand Policies. Most manufacturers, and certainly almost all of the larger ones, have for a long time recognized the wisdom of adopting brands. Nevertheless there are still many producers who, for one reason or another, do not brand or advertise their products.

Marketing Unbranded Goods. Prominent among the reasons for producing and marketing unbranded goods is a lack of appreciation for the value of established brands and absence of initiative or financial resources necessary to establish a selling and advertising organization. Many a manufacturer, from lack of foresight, may be satisfied to follow the line of least sales resistance and sell the total output to one or a limited number of wholesalers or other purchasers so long as an immediate profit is forthcoming. Furthermore, the quantity of his output may be too small to justify the requisite outlay to develop consumer demand for his product even if it were identified.

In selling unbranded goods, a manufacturer finds it possible to cater to purchasers who are anxious to secure supplies for private branding. This may sometimes afford an outlet for surplus goods even when a manufacturer generally produces under his own label. He may have overestimated the demand for his trade-marked article and produced more than could be absorbed by his market. To prevent depreciation from obsolescence and physical deterioration and to save interest on the capital tied up in extra inventories, he is glad to dispose of his surplus for sale under a private label, so long as his own brand remains protected. Again, it is the policy of some manufacturers to sell only first-class products under their own brand and to dispose of imperfect and inferior goods to wholesalers or retailers who label them with their private brands. It should not be inferred from this statement that all private brands represent goods of an inferior quality. On the contrary, many private brands are of the best quality.

Unbranded goods make it possible for a manufacturer to shade his prices when warranted by general business conditions or other pertinent factors. Previous purchasers, because of lack of knowledge as to the exact sources of supply of these lower-priced goods by their competitors, are not likely to resent the practice. A manufacturer of branded goods, on the other hand, feels a moral obligation to maintain his selling price even when added stimulation to business through lowered prices may be deemed advisable, merely because customers still have large quantities of his products on hand for which the higher price has been charged.

Manufacturers of unbranded goods are, however, subject to a number of operating disadvantages. They are not in a strong strategic position, especially if products can be readily duplicated, as is true of most staples. Unless the manufacturer enjoys peculiar advantages in production or remains very efficient, his business is precarious and may easily be lost. He must frequently compete on a strictly price basis, and hence may lose to a more efficient competitor and suddenly find himself without a market. One of the chief interests of either wholesalers or retailers who purchase goods for private branding is in securing goods at the lowest possible prices. They will therefore purchase goods wherever they can secure the greatest economies, for little prestige attaches to any one producer of unbranded merchandise except that prestige which arises from the rendering of superior service, integrity, and the practice of living up to contracts. It is probably for this reason that such manufacturers, with the exception of those operating in a field in which branding is relatively unimportant, usually remain small and unknown. Consequently, it behooves a manufacturer to exercise some care and judgment in determining the feasibility of establishing his own brand or producing unbranded and unadvertised goods.

Blanket vs. Individual Brands. When a manufacturer produces two or more articles which are to be branded, it becomes necessary to decide whether the same brand, commonly referred to as a "house" or "blanket" brand, should be used for all the products of similar grade or whether separate brands should be adopted for individual items. Probably the majority of manufacturers who produce several articles of similar quality to sell to the same class of trade use one blanket brand or trademark for all the goods in the line, as illustrated by Heinz, Libby, or Del Monte food products, Elizabeth Arden or Pond's cosmetics, Johnson & Johnson first aid and toilet goods items, and Parker or Eversharp pens and pencils. Individual rather than blanket brands are used, however, by a number of the country's most important manufacturers including Procter & Gamble Company, the International Shoe Company, Lever Brothers and Unilever, Ltd., and the General Motors Corporation.

A blanket or house brand enables the buyer to identify all the products bearing that mark, aids in establishing consumer recognition, and extends the prestige of the whole line to the individual items in the family. This facilitates the introduction of new items, so long as they retain the same quality. Furthermore, several products can be called to the attention of consumers in a single advertisement, with major attention being focused either on one of the items featured or on the brand itself.

Yet the adoption of a house brand presents some very difficult problems. In the first place, it becomes essential that the same standard of quality be maintained for all products bearing a given mark. Should a single product prove inferior in quality to that of the general group, it is likely to impair the reputation of the entire line. In the second place, care must be exercised to see that the products are closely allied in use or sometimes in manufacture. A blanket brand cannot be advantageously applied to commodities that are unrelated or whose association may not prove desirable, as in the case of soaps and cooking fats or glue and hams. A third precaution requires that the variety of articles to which a blanket brand is applied be not too large, otherwise the brand becomes merely defensive. A blanket brand does not lend itself to the same degree of aggressive selling and cannot be so highly individualized as a trademark that is applied to a single product. This probably constitutes the single most important objection to blanket or house brands. For example: "Crisco" certainly means more to the average housewife than any blanket brand like "57," merely because the former applies to a single product, the association of which is complete as soon as the name is seen or pronounced, while the latter refers to a line of food products with a more or less vague reference to any particular item of the group.

Multiple Brands for the Same Type of Product. Some manufacturers pursue a policy which involves establishing two or more brands covering the same class of goods. One purpose may be to meet price competition. Demands for a cheaper brand of a product, for example, as a means of stimulating sales, recur during periods of depression. In other instances, the need for a cheaper brand of a given product arises from keen competition in the field. A "fighting brand" is then adopted, with the express purpose of meeting all price competition. This may or may not involve a change in quality or in channels of distribution.

Another reason for several brands of a given product or class of goods may be the desire to satisfy different outlets. Some wholesalers and large-scale retailers may demand a cheaper brand than the regular one, and their business may be sufficiently extensive to justify its adoption. The International Shoe Company, for example, through its different manufacturing plants, produces a number of brands so that all types of stores may be served with shoes varying in price from the lowest to almost the highest. The estab-

lishment of a cheaper brand also enables producers to dispose of imperfect and inferior merchandise without jeopardizing their regular brands.

Perhaps the most important reason for the use of multiple brands on the same type of product is the desire to reach all or a number of segments of the ultimate consumer market. An example is provided by the brands of hats marketed by the three divisions of Hat Corp. of America. The most expensive line, Cavanagh, is sold to upper income groups through carefully selected dealers and by means of advertisements in magazines of travel, world affairs, and the arts. The Knox line has been specially styled to appeal to younger men, is advertised in magazines of fairly wide circulation, and sold on the basis of appeals that involve exceptional style interest. The Dobbs line is most widely distributed and is advertised in mass media such as *Life* magazine to appeal to the broad middle income market.[5]

Another example of market segmentation is provided by the Procter & Gamble Company, which, in 1956, marketed two brands of toothpaste (Gleem and Crest), three vegetable shortenings (Crisco, Whirl, and Fluffo), several brands of packaged household soaps and detergents (Tide, Cheer, Oxydol, Duz, Dreft, and Dash), as well as multiple brands for other specific types of products. It has been reported that the theory which underlies the company's strategy is that no one detergent or shampoo will satisfy every housewife, and that the best way to increase the company's share of a particular commodity market is to launch a second or a third brand to appeal to different segments of that market. A new brand may differ only slightly in actual performance from some established brand, but it must have some distinctive characteristic that can be dramatized in advertising. According to advertising appeals commonly used, "Tide gets clothes cleaner," Cheer gets them "whiter," and Oxydol gets them "detergent" clean . . . "and bleach-white."[6] Thus, the company has a major specific selling appeal identified with each of several individual products and can offer to each customer something which is most in line with specific buying interests.

Similar examples are to be found in the cigarette manufacturing industry. Most of the major producers have a variety of brands. Illustrative is Philip Morris, Inc. which manufactures and markets the following brands: English Ovals, Benson & Hedges, Parliament, Philip Morris regular and long size, Marlboro, and Spud. By this diversity of brands, the company is able to serve all segments of the market—consumers who wish exclusiveness in price and package, those who like ordinary cigarettes, long sizes, filters, or menthol flavor.

[5] Roberta Gerry, "Why 3 Ad Agencies for One Company?" *Printers' Ink,* August 17, 1956, pp. 31–33.

[6] Spencer Klaw, "Winner and Still Champion: P & G," *Fortune,* March, 1956, pp. 104 ff.

Private Brand Policies of Wholesalers. Many manufacturers of nationally advertised products are strongly opposed to the use of private brands by wholesalers. Some of them are so hostile to such firms that they resort to retaliatory measures, one of which consists in the elimination of the wholesaler from the chain of distribution as far as they are able, even though considerable expenditures may be involved in undertaking to perform his functions. Other manufacturers limit their business connections to non-private brand distributors, resulting in considerable inconvenience to the public because of the narrow distribution involved in the method.

Wholesalers, on the other hand, are desirous of securing the advantages inherent in private branding, but are at the same time loath to antagonize manufacturers whose goods they handle. Although a few of them have abandoned the plan in order to pacify complaining manufacturers and because of failure to realize their hopes for increased profits, a very large number of wholesalers have substantial private brand programs.

So far as the public is concerned, arguments have been advanced by its advocates to the effect that private branding has beneficial results. Opponents naturally deride the plan and represent it as extremely detrimental to the general welfare of the consumer. It is alleged that distributors' brands are less reliable than manufacturers' brands and that they involve a tremendous multiplicity in brands. This is said to be both confusing to the consuming public and altogether too costly.

As a result of this conflict and such a mass of contradictory statements, there is a problem as to the attitude to assume toward private branding. To arrive at a satisfactory solution, if such be possible, it becomes necessary to examine the question from all angles, namely from the standpoint of the manufacturer, the private brander, and the consuming public at large.

Reasons for Private Branding. Many wholesalers stress their own private brands because they yield a higher percentage of gross profit. Some manufacturers of heavily advertised brands have cut wholesalers' discounts to a minimum and attempt to justify such action by the argument that, since they have created the demand for the product, the wholesaler does not have to exert much selling effort and should therefore be compensated by a narrower margin.

A second reason may be designated as self-preservation. Direct sale to retailers has been most common among manufacturers of highly advertised lines of products. Many wholesalers, consequently, entertain the fear that as soon as they develop a sufficient volume of sales on a manufacturer's line, he may establish his own integrated wholesaling system. Wholesalers with brands of their own are in a better position to compete with direct selling manufacturers.

Third, private brands are often established by wholesalers as a means of protection against their own salesmen. Many wholesalers' salesmen are generally dominant and aggressive individuals who know their trade intimately and secure much of their business because of their impressive personality rather than on the basis of the reputation of the house they represent. This knowledge enhances the salesman's bargaining power, of which he sometimes takes full advantage. He may thus threaten to join a competitor if his demands are disregarded and divert the bulk of his trade from his present employer. Considerable weight may be attached to his argument so long as the same goods could be obtained by his customers from a competing concern. When the wholesaler develops a market for his own exclusive brands, his salesmen's activities intensify demand for these products, thereby diminishing the danger of losing trade when a popular salesman severs connections with the house.

The ability to control repeat business is a fourth important reason for private brands. Since manufacturers' brands, except those distributed through exclusive agencies, are sold by competing wholesalers, retailers may purchase them from a number of sources. The private brand is, however, available only from the wholesaler who controls it.

Fifth, private brands are used to avoid direct price competition. Price competition is generally keenest among sellers of highly advertised national brands who stress price as a patronage appeal. A private brand wholesaler may carry such items only for completeness of stock and attempt to develop business for his own brand which, for practical purposes, is not directly comparable with lines handled by competitors. Private brands also permit sectional wholesalers to extend their radius of operations over larger territories than is possible in the distribution of national brands which are sold by distant local wholesalers who compete with the benefit of a transportation cost advantage.

Still another reason is that private brands permit greater freedom in pricing. Prices of products bearing manufacturers' brands are frequently fixed by the producers in a desire to maintain resale prices. Under such circumstances a wholesaler has practically no freedom to vary prices even when trade and other conditions would seem to warrant a certain amount of price-cutting. When a wholesaler affixes his own brand to the merchandise, he is perfectly free, within certain legal bounds, to price his goods in accordance with the dictates of his judgment. In a period of poor business, or in territories in which keen competition prevails, a little variation in price may be a determining factor in the volume of business ultimately secured.

Prerequisites to a Successful Private Brand Policy. To secure satisfactory results from marketing private brand merchandise, two important requirements must be met by wholesalers. First, in affixing his own label, the

wholesaler must assume full responsibility for the quality of the product bearing that brand. This necessitates purchasing in large quantities in order to insure a regular supply and strict uniformity in quality. Experience has shown that, in order to maintain a uniform quality of his product and to secure economies in buying requisite to success in the undertaking, a wholesaler must purchase goods for private branding in larger quantities than when dealing entirely in nationally advertised goods. Larger stocks must be carried, so that private brands usually have a slower rate of turnover than manufacturers' brands of similar goods.

A second merchandising problem arising from the handling of private brands relates to the assumption of the task of demand creation. Successful utilization of a private brand necessitates the establishment of a sales promotion department and the organization of a more aggressive sales force, closely resembling the type of salesmanship used by specialty manufacturers. Salesmen must be trained to render such special assistance to retailers as will induce the latter to cooperate in promoting sales of the private brand merchandise. This may mean that a wholesaler whose sales organization is geared for the promotion of private brands may find it difficult and expensive to handle manufacturers' brands through the same sales force. While the latter type of merchandise may largely require ordinary selling, the former class of goods calls for the exercise of real salesmanship. Whether the two qualities can be advantageously combined in a sales organization is debatable.

Private Branding by Retailers. In the grocery trade it is common to find retailers' private brands for some lines of merchandise, such as coffee, tea, flour, and baked goods. In addition there are private brands of such articles as soap, olives, cereals, cocoa, spices, canned fruits and vegetables, and bottled goods. Chain stores either manufacture some of their own goods which are naturally sold under their own blanket trademark (as illustrated by the "Ann Page" brand of the A. & P. Company) or purchase unbranded supplies to which their private label is attached. Mail order houses and many department stores follow a similar policy, at least in connection with certain items of merchandise. Some department stores, for example, apply their private label to men's clothing, shoes, and furnishings. There is also a rapidly growing tendency for buying associations of retailers to adopt distinctive brands for use by their respective members, as illustrated by the "AMC" and "Aimcee" brands used by the members of one department store group for a variety of products ranging from cosmetics to electrical appliances.

Several reasons may be given for the establishment of private brands by retailers. In the first place, many retailers believe that it is good advertising, attracting to their stores customers whose trade they are likely to retain.

It strengthens a retailer's hold upon the trade of his customers once a reputation has been secured for the brand and enables him to retain all the advantages of his advertising. In the second place, there is a possibility of larger profits on the private brands. It constitutes a means of avoiding direct price competition. He is not forced to mark down his own brands as a result of price-cutting by competitors, a condition that would arise in connection with well-known and advertised brands of manufacturers or wholesalers, although on these the total profit may be greater on account of the smaller extent of sales resistance. Third, some of the large retail institutions prefer private brands because they wish to avoid controversies that arise with manufacturers who attempt to maintain standardized resale prices. Fourth, the larger retailers frequently take over the entire output of certain manufacturing plants, and hence secure nondescript merchandise at lower prices than would be charged for branded goods of similar grade, which enables them to sell under their own labels at lower prices and yet obtain a wider margin of profit. Finally, private branding permits greater freedom in the selection of sources of supply, as goods are then bought by specification and strictly on a basis of quality and price, not because of their brand reputation.

Private branding by retail institutions is likely to prove most successful when they enjoy considerable prestige in their respective markets and when the volume of business possible on such goods justifies the expenditure requisite to the aggressive utilization of such a policy. Mail order companies do not market most of their items primarily on the brand reputation, since most of their stock is either unbranded or bears the company's own labels which are not widely known except to their own customers, who purchase principally because of the reputation of the vendor. Some mail order companies' private brands result from factory control or ownership and sometimes from a refusal of manufacturers to sell their advertised branded articles through a mail order house except under a disguised name. Chain stores and department stores fall in the same category. Not every department store can successfully inaugurate a policy of selling private brand goods. Only when there is sufficient confidence in the integrity and reliability of such a firm, is a private brand likely to succeed. This probably accounts for the fact that private brands are usually introduced by department stores on goods on which they have succeeded in establishing a good reputation for quality, style, workmanship, and other pertinent characteristics.

Branding Materials and Parts. There is a growing tendency among producers of materials and parts to perpetuate the identity of their products, with very good results in some cases. The commonest examples of such attempts are to be found in the production of batteries for automobiles, and of automobile bearings, bodies, tires, and other equipment. Much of

our radio and television equipment and numerous accessories, including tubes, transistors, and other parts, are thus branded and advertised. Manufacturers of rubber heels have also attempted to identify their product as a means of influencing shoe manufacturers to use rubber heels of a specified brand.

In many such cases there are two distinct markets for the product: first, the manufacturer, who uses the product as a part of the original equipment, and second, the consumer, who buys it for replacement purposes. Branding not only may occasionally force a manufacturer of the finished product to purchase the branded part or material but will make it possible for dealers and service stations to be identified with the part, so that necessary services involving repairs, inspection, and installation may be rendered satisfactorily. This in turn results in purchasing such parts for replacement purposes entirely by brand, especially when the product is of a relatively high unit value or high replacement frequency.

The branding of textile fibers, yarns, and cloth has become of increasing significance since the advent of man-made or synthetic fibers. Among brand names commonly featured in trade and consumer advertising for apparel are Milium, Helenca, Dynel, Celanese, Acrilan, and Chromspun. Even among natural fiber cloth, it is fairly common to find brand name advertising in consumer publications for such materials as Aberfoyle cotton, Harris Tweed, and Forstmann woolens. In many instances these branded materials are identified by labels on finished items of apparel and constitute an important selling feature of the product.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:

   a) policy
   b) major policy
   c) minor policy
   d) blanket brand
   e) house brand
   f) fighting brand
   g) private brand
   h) distributors' brand

2. What major advantages flow from the adoption of sound marketing policies?
3. What are the principal motives which explain manufacturers' interest in the development of new products?
4. Assume that a manufacturing firm is considering the advisability of adding a new product to its line. Approximately 20 different product ideas have been suggested for consideration by the company. What criteria should be used to determine which of these might be most acceptable as product additions? Explain.
5. In what respects does the so-called "full line" manufacturer have marketing advantages over specialized manufacturers?
6. In the 1950's, Pillsbury Mills, Inc. expanded by acquiring the assets of Ballard and Ballard Company and the Duff Baking Mix Division of American

Home Products Corporation. Also in the 1950's, Procter & Gamble Co. purchased the Duncan Hines line of prepared cake mixes from the Nebraska Consolidated Mills of Omaha, and it bought Charmin Paper Mills, Inc. Explain why one of these sets of mergers provoked a complaint by the Federal Trade Commission and the other did not.

7. What are the principal forms or types of product modification?
8. Explain the main reasons for the use of brand names in advertising.
9. Manufacturers' brands are often referred to as national brands. Does this mean that private brands are not national? Does it mean that manufacturers' brands cannot be local or regional?
10. In spite of the substantial advantages claimed for marketing of branded goods, many manufacturers do not have any brand names of their own, preferring to market unbranded goods which are purchased by the owners of private brands. How can you explain this preference by some companies? What disadvantages are experienced by such marketers of unbranded items?
11. Under what conditions is it advisable for a manufacturer to use a blanket brand for a line of products? What special precautions should be observed in the case of a "blanket brand policy"?
12. Why do many manufacturing companies have several different brands for the same type of product? When is such a policy preferable to a blanket brand policy?
13. What are the main reasons for private brand policies on the part of wholesalers? Of retailers? What conditions or circumstances are essential for the successful development of a private brand policy? Explain.
14. Is it ethical for a manufacturer to brand a product, advertise the brand to consumers, and then allow narrow margins to wholesalers who must handle the product because consumers, and in turn retailers, are demanding it?
15. A general-line merchandise wholesaler located in Arizona does business over a wide area. The company has followed the strict policy of fully cooperating with national advertisers. In addition, it has limited the number of brands in each line so that there is not too much competition within each line. As a result of this policy, the company has been made the exclusive agent for a large number of products. A large flour mill recently approached the sales manager and made an attractive offer which would have enabled the wholesaler to obtain a high quality all-purpose flour packed under the wholesaler's label. The offer was declined. Similar offers in the past on other lines have also been rejected. The company's sales and profits have shown a favorable trend over the years. In view of the widespread use of private labels, how can the success of this wholesaler be explained? If you were the sales manager, would you have turned down the flour mill's offer? (The margin offered was approximately one and one-half times that obtained on competing national brands.) Explain.
16. For some fifteen years the Anderson Company has manufactured a rather fine antiseptic oil for babies. The company has spent considerable sums promoting the brand name "Smoothskin Baby Oil" which has now become an established product. Quite by accident the company's chemist developed an excellent insect-bite healer from the waste oil of the Smoothskin Baby

Oil. The sales promotion director faces the problem of whether the "family" relationship between these products should and can be brought to the public's notice. It should be mentioned that the baby oil is known generally and asked for by most buyers as simply Smoothskin. What would be your decision if you were in the place of the sales promotion director? Explain.

17. A small manufacturer of water pumps has been branding his products and selling them through wholesale hardware dealers. The pumps are adapted primarily to farm use. The small scale of operations has not permitted national advertising, so promotional work has been left to the wholesalers and hardware stores, neither of whom were "pushing" the product enthusiastically. Sales have been such that the company has been forced to restrict output to about one-half of its capacity. A large retail chain organization has approached the officials of this company with an offer to take over the entire output. The price, however, was to be 5% lower than that now received from wholesalers. If the offer is accepted, the company must abandon its brand name, as the chain will use its own private brand. What is to be gained, and what may be the danger of the above proposed arrangement?

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DISTRIBUTION POLICIES

Some of the distribution policies guiding business enterprises have already been discussed in appropriate parts of this book. For example, a fairly detailed treatment was presented in Chapter 2 of the nature of distribution channels, their vertical and horizontal aspects, and the various factors involved in a proper choice for a given type of merchandise. Similarly, throughout the parts dealing with retailing and wholesaling institutions, each principal type was examined in the light of its advantages and limitations and possible use as part of a channel of distribution for certain goods.

There remain, however, several important questions of distribution policy that have not been previously covered. One of these relates to the number of outlets to be used in a given channel or on a given level of distribution. Another has to do with the service policies that are related to distribution policies. A third deals with leasing as a distribution policy or strategy.

General versus Limited Distribution. Following the selection of a channel or channels of distribution for a given product or line of merchandise, it remains to be determined, by way of policy, whether the distribution should be effected through the largest possible number of outlets on a given level or plane or through a highly selected group of such outlets. The first policy involves what may be termed as "general distribution" or blanket coverage of the entire market; the second type of policy may take the form of selective distribution or exclusive agency arrangement, both of which are discussed in detail in this chapter.

On the surface it might appear best for a seller to obtain the widest possible distribution for his product or line of merchandise and thus secure for it the maximum exposure to ultimate consumers or business buyers. This would obviously call for a policy of general distribution. Actually, however, such a policy is quite limited in application, partly because of the cost factor and partly on account of the nature of the goods and the buying behavior of consumers and other customers.

In the field of consumer goods, widespread or general distribution is confined almost altogether to convenience goods, and even there it is limited to the leading brands of the most widely used and most frequently replaced or purchased items on a convenience basis by the vast majority of the consuming public. In this category are such items as cigarettes, candy bars, matches, toothpaste, bread, and aspirin tablets all of which are sold through a multiplicity of channels with both vertical and horizontal variants. For such products maximum sales can be realized best in this manner. In the long run, the costs involved and the buying pattern of consumers determine the kinds and numbers of outlets and the relative importance of each outlet type through which a given product will be distributed. This applies to wholesale as well as to retail types of outlets, the latter determining the former. For example, a product sold through drugstores is also likely to be handled by wholesale drug firms that normally serve the retail outlets. It follows that if more than one type of retail outlet is used, the same would tend to be equally true of the wholesale level of distribution. That is why some cosmetics and toilet goods are sold not only through drug wholesalers, but also through wholesale grocers, tobacco jobbers, drygoods wholesalers, sundry wholesalers, and others in order to reach drugstores, grocery stores, drygoods and department stores, confectionery establishments, and general stores.

In the industrial market, a policy of general distribution is adopted only for commodities that are highly standardized and that have a horizontal market (i.e., one consisting of business users in many different kinds of industries and trades). Illustrative are small hand tools, cleaning preparations, and other standard supplies.

Policies of Limited Distribution

While a policy of general distribution is appropriate under the circumstances indicated above, the great majority of manufactured items are marketed through a selected or limited number of outlets on the retail or wholesale level of distribution, or on both such levels. An extreme form of this policy is known as the *exclusive agency method of distribution,* while a more liberal application of similar concepts gives rise to what is known as *selective distribution.*

Exclusive Agency Method of Distribution. This arrangement presupposes a definite agreement between principal and agent, each assuming certain obligations. The relationship is exclusive in the sense that the vendor agrees to sell his goods or services within a certain territory only through a single dealer or through a limited number of such representatives. The agreement not to sell to any representative other than the one to whom the privilege is granted results in a relationship known as a single, unlimited, exclusive

agency. Joint exclusive agencies exist whenever more than one representative is selected to serve a given territory.

Both the size of territory to be covered and the number of representatives appointed depend upon the type of commodity or service to be sold and the density of the market, judged usually by the number and size of potential customers in the case of industrial goods and by the extent of the population in the case of consumer goods. In the marketing of automobiles, for example, one representative dealer may suffice for the Lincoln or Cadillac in a community of about 300,000; but several dealers are required to handle Chevrolets, Plymouths, or Fords in the same community if the territory is to be covered intensively. The number of prospects to be cultivated for the latter cars exceeds by far the number of possible purchasers for the more expensive product. When paints and varnishes are distributed on this basis, it is usually advisable to have a number of dealers handle the product in different parts of a large city. Men's clothing, on the other hand, is more often distributed through a single retailer in a community. Not infrequently a manufacturer combines the two methods, appointing single exclusive agents for areas with a sparse population and two or more agents for large cities and other concentrated markets.

While the term "agent" or "agency" is commonly used in connection with an exclusive dealing arrangement, actually there is no agency relationship in the legal sense. The dealer having the so-called agency does not act for a principal. Since he purchases the goods outright and takes full title to them, he acts on his own behalf in the conduct of the business and not as an agent for someone else. As such he is an independent businessman with full dominion over the goods in which he deals and over his operating methods. His actions as an "authorized agent" are subject only to certain price and other restrictions as mutually agreed upon by a cancelable arrangement.

Exclusive agencies are sometimes granted by manufacturers to wholesalers who may, in turn, be required to select retail outlets in their respective territories or to sell the line to all dealers who qualify financially and otherwise. When agencies are given to wholesalers of consumer goods, as is common in the musical instrument field, the electrical trade, and the automotive accessories industry, or to industrial distributors, exclusive territories are naturally wider than when such agencies are extended to retailers. The exclusive agency is, however, most common in lines which are generally distributed directly to retailers.

Exclusive Agency Agreements. Exclusive agency agreements may be formal or informal. Some manufacturers have no written contracts with their wholesalers or dealers, preferring to operate in this manner because they believe that it affords greater flexibility. When, however, the manufacturer's line of goods constitutes all or a very large share of the dealer's total sales

volume, and possible misunderstandings about responsibilities of the parties may become matters of serious concern to either, it is common to spell out all pertinent matters in a written contract. Such contracts are sometimes called franchise agreements, and the expression "franchised dealer" or "franchised distributor" is often used to designate the retailer or wholesaler who has signed such an agreement with a manufacturer. The specific points covered in contracts vary considerably, but a clearer understanding of the nature of exclusive agency relationships can be gained from considering some of the items commonly covered in them, as indicated in the following paragraphs.

PRODUCTS: The contract may enumerate exactly what goods are covered by the agreement, which is especially important in cases where the manufacturer does not desire to distribute all of his products through exclusive agents.

CLASSES OF CUSTOMERS: The agreement may be limited to certain classes or types of customers. The manufacturer sometimes retains the right to sell direct to some customers such as very large industrial users or national chain store organizations that purchase through central buying offices.

TERRITORY: The area in which the agent has exclusive rights of sale may be defined. Sometimes this is supplemented by an agreement to the effect that the agent shall not make any sales outside this territory, although this is becoming less common, as indicated by certain legal implications discussed at a later point.

INVENTORY AND SERVICES: The dealer may agree to maintain adequate inventories of specified items covered by the franchise. In the case of consumer durables and industrial equipment, this may also be broadened to include repair parts and the types of installation and repair services which the agent is to provide for his customers.

PRICES AND DISCOUNTS: Prices to be paid to the manufacturer and to be charged to the agent's customers are often specified. Even though it may not be practical to incorporate specific selling prices in the agreement, the basis for price determination is often indicated. For example, in a contract used by a wholesale distributor for a line of furnaces, the retail dealer is granted in the franchise a quantity discount according to a schedule[1] based on the dealer's annual volume of purchases. It is sometimes required that the dealer agree to maintain the manufacturer's resale prices.

QUOTAS: In return for the privilege of becoming an exclusive agent, the dealer is usually expected to obtain a satisfactory volume of sales. Some minimum level of dollar or unit purchases may be specified in the contract,

[1] Trade and quantity discounts are discussed in Chapter 33.

or some method of arriving at annual quotas may be defined. For example, an exclusive wholesale distributor for a line of major household appliances may have to agree to obtain a total sales volume within his territory which is determined by applying a percentage to the national sales objective of the manufacturer. The percentage may be ascertained on the basis of the number of wired homes within the distributor's territory as a per cent of the total number of such homes throughout the country. Failure of the agent to obtain the level of quota sales may be a cause for terminating, on due notice, the franchise agreement.[2]

ADVERTISING: Advertising and sales promotional obligations of both parties may be indicated. This may include some statement about the quality or ethical standards to be maintained in local dealer advertising. The amount of advertising to be placed by the dealer or distributor and the degree to which the manufacturer will cooperate in payment for it may also be specified.

COMPETITIVE PRODUCTS: It is sometimes provided that the agent shall deal only in products furnished by the manufacturer or, if the agent carries a diversified product line, that he shall not deal in any products that are directly competitive with those of the manufacturer. As explained in a later section, such exclusive dealing covenants may involve complex legal questions. It is, therefore, more common for manufacturers to obtain exclusive dealing arrangements by other means—by oral agreements (which may also be found illegal on the basis of intent or effect), by refusing to grant exclusive agency contracts to prospective dealers who handle a competitive line, or by terminating contracts with dealers who take on a competitive line.

DURATION, TERMINATION, PERPETUATION: The duration of the contract is usually specified. Such agreements are normally for a period of one year, but contain a provision for renewal. They can, as a rule, be terminated by the agent on reasonably short notice, say thirty days, or by the manufacturer; but in the latter case termination may be limited to certain causes which are stated in the agreement. In the contracts used by one of the leading automobile manufacturers, the dealer may arrange for anyone who is active in his business to succeed him as the franchise holder in event of death or incapacity. Furthermore, since the passage of the Automobile

[2] Some strictures have been placed upon the manufacturer in this regard by the passage of the federal Automobile Franchise Act (Public Law 1026, approved August 8, 1956), requiring automobile manufacturers to act in "good faith" in such matters. The stated purpose of this act was to enable franchise automobile dealers to bring suit in a federal court "to recover damages sustained by reason of the failure of automobile manufacturers to act in good faith in complying with the terms of franchises or in terminating or not renewing franchises with their dealers." This act is intended to curb arbitrary and high-handed actions allegedly taken by the stronger of the two parties to the agreement.

Franchise Act some companies have announced agreements for an initial period of three to five years, all subject to renewal.

Advantages and Disadvantages to Manufacturers. Manufacturers often desire to retain close control over resale prices, kind of selling, and servicing standards. When it is not possible for a manufacturer to sell direct to business users or ultimate consumers, the exclusive agency plan offers the best means of effecting such control. By limiting distribution to exclusive agents, thus providing each of them with a reasonably large sales and profit potential, the manufacturer may expect special and concentrated sales effort from his distributive organization. Once agencies have been established, there is little need for ordinary personal selling effort on his part. His salesmen can devote more time to educational and service work. When quotas are incorporated in the contracts, it is easier to count on a certain amount of business in advance. It is thus possible to develop a regular and economical schedule of manufacturing. Use of exclusive agencies holds to a minimum the number of accounts with which the manufacturer must do business. This tends to reduce certain expenses involved in the movement of physical supply and in communications, such as credit investigations, shipping, accounting, and correspondence.

When the number of outlets for a manufacturer's product is very limited, there is the disadvantage that exposure to sale and perhaps actual sales may also be unduly limited. The problem of selecting an adequate number of the most desirable outlets is usually rather complex. Often the most desirable outlets in the trade are already pre-empted as exclusive agents for competitive products. If mass market advertising is used, some circulation may be wasted because the network of distributing organizations does not always provide full market coverage. When a particular agent does not do a good selling job, the manufacturer's sales are likely to suffer greatly in a given market area. While the manufacturer has the right to terminate contracts with unsatisfactory agents, he is often reluctant to do so because of difficulties in locating more satisfactory agents, or because of a fear of developing antagonism among other agents who are doing a satisfactory job. To illustrate, in the automobile industry in the mid-1950's leading manufacturers disenfranchised a considerable number of well-established dealers who were unable to meet their sales quotas in the face of competition from large new retail agencies that operated on a high volume, low overhead, aggressive advertising approach. Termination of such franchises was one of a number of practices carefully investigated in a 1956 Congressional study of marketing practices in the automobile industry and particularly of certain alleged monopolistic implications attributed to the bigness of the General Motors Corporation. It was also a condition that promoted considerable unrest among automobile dealers, led them to make unified and persistent demands upon manufacturers, and resulted in various liberalizations in customary

franchise agreements and in the enactment of the Automobile Franchise Act.[3]

Advantages and Disadvantages to Middlemen. Several benefits may accrue to wholesalers and retailers who receive exclusive rights to sell a line of goods in a given area. Parallel lines may be eliminated, thus facilitating both a concentration of sales effort and a more rapid rate of stock turn. Manufacturer as well as dealer promotional effort should be reflected directly in larger sales volume, with little of the beneficial effects carried over to the business of competitors in the area. Then, too, closer cooperation and more concessions can be expected from manufacturers than would otherwise be possible. A profitable margin is easier to maintain because there is no competitor in the area to cut prices on identical goods. As the product is exclusive, the consumer has little opportunity to shop around and compare prices on the identical item. If the line gains consumer acceptance, repeat sales are assured because the customer will seek out the dealer handling the particular brand. As a matter of fact, good will created for the exclusive line may result in increased trade for other items carried by the retailer or distributor.

This method of distribution is not without disadvantages to middlemen. First, sales volume may be seriously affected where strong brand preferences have been developed in competing lines. Then there is always a possibility of overstocking, because quotas set by manufacturers are frequently larger than can be absorbed by the market which the agent serves. Further, it becomes more difficult to meet competition from price-cutters handling similar lines, since manufacturers operating on this basis usually stipulate resale prices from which it is inadvisable to deviate. In addition, the policy invites increased competition from exclusive agents selling parallel lines.

The principal disadvantage, however, consists in possible termination of the arrangement on the initiative of the manufacturer. An agency is sometimes withdrawn from one agent and transferred to another who is supposedly better qualified to render satisfactory service. More often the exclusive agency plan is used by a producer as a means of breaking into the market and securing initial distribution. Once the line becomes well established in the public mind, the exclusive sales privilege may be withdrawn. The agent who has spent time, money, and effort in his pioneer attempt to build up patronage will then find several dealers in the community taking advantage of the situation.

Some Specific Possibilities and Limitations. From what has been said above, it should be apparent that exclusive agencies cannot *normally* be used in the distribution of convenience goods which consumers desire to

[3] "Detroit Woos Its Dealers With a Basic Change in Auto Selling," *Business Week,* March 3, 1956, pp. 104–12.

purchase at the nearest stores, nor for many items of shopping goods where consumers make comparisons in several stores, which circumstance indicates the need for more than one retail outlet. Exclusive agencies are used by many manufacturers under certain conditions. The more usual of these may be listed for convenience as follows:

1. In the marketing of specialty goods which have a sufficient attraction to induce consumers to put forth unusual effort to visit the one establishment where they are sold.
2. In introducing new goods or in breaking into new markets. Such a circumstance often prompts the use of an exclusive agency even for convenience or shopping goods as an introductory device, especially when the agents selected for this purpose are large chain organizations or department stores that are in a position to provide substantial advertising and sales promotion support and which can practically insure a significant volume of sales during an introductory period.
3. When dealers must make a large investment in order to carry a representative stock of the line produced by a manufacturer. This is often true of such items as men's suits and major household appliances.
4. Where special installation or repair services must be made available in connection with the sale of a product. Farm tractors, automobiles, household air conditioning equipment, and furnaces are illustrative in the field of consumer goods. Among types of industrial or business goods meeting this criterion and commonly sold on an exclusive agency basis by distributors are barber chairs, hospital operating room equipment, road construction machinery, industrial trucks for materials-handling purposes, and certain types of lathes and drilling equipment.

Selective Distribution. A distribution policy which is growing in importance is that of *selecting only those distributors or outlets that are able best to serve the manufacturer or wholesaler making the selection.* It is similar to the policy of distributing through exclusive agencies but differs in that several dealers or distributors are often used in a single trading area, and arrangements are usually less formal and not as restrictive. It can be applied to convenience, shopping, or specialty goods, except that a larger number of outlets must be chosen for the first-named class of goods. The policy results in eliminating sales to dealers or wholesalers whose orders are so small as to make their business unprofitable or who, because of a bad credit standing, a reputation for making too many returns, or for asking too much service, are not deemed profitable customers.

Manufacturers who follow a policy of selective distribution do so in order to obtain most of the advantages that can be realized through an exclusive agency policy, but to accomplish this objective without unduly restricting the number of customers. A selective distribution policy is often feasible

under conditions when it would be unthinkable to follow a policy of exclusive agency distribution.

Some Illustrations. A drug wholesaler formerly employed a large staff of salesmen who called on all drugstores in his trading area. Although some retailers purchased most of their requirements from this wholesaler, others gave him only occasional or token orders. From a sales analysis it was learned that about 80 per cent of total sales volume was accounted for by orders received from only 24 per cent of the total number of customers. This meant that about three-fourths of total selling effort in terms of sales calls was devoted to the group of customers that contributed only one-fifth of the sales volume. As a result of additional studies, the wholesaler concluded that it was not ordinarily worthwhile to continue soliciting business from a drugstore unless sales to it amounted to about 40 per cent or more of the store's requirements for types of merchandise handled by the wholesaler. By discontinuing sales calls upon outlets that fell far short of meeting this criterion, and by having salesmen spend a larger amount of time per call on customers who bought a large share of their requirements from the house, it was possible to help retailers with sales training and promotional work and thereby increase their purchases at any one time and in total.

A manufacturer of a wide line of standardized rubber industrial products has potential users in almost all types of manufacturing industries. To reach such users, the company sells through a large number of industrial distributors in a variety of trade classifications. Attempts are made to limit distribution to firms that will devote special attention to the line. In doing so, it is easier to insure that each distributor will have a reasonable opportunity to obtain an adequate volume of profitable sales, provided proper selling effort is used. When it appears that a given market area has sufficient potential to justify an increase in the number of distributors in it, additional wholesale outlets are carefully selected. As a basis for the selection, information is obtained from complete credit investigations of prospective distributors obtained from a national credit agency, correspondence with other manufacturers of noncompetitive products that sell through the distributors to determine the quality of services they provide to suppliers, interviews with selected industrial purchasing agents in the area to determine the standing of distributors among customers, and personal visitations at each distributor's place of business to ascertain the quality of his sales and inside personnel, the number and types of items handled, extent of the trading area served, adequacy of physical facilities, financial condition of the firm, and other relevant matters.

Application of the Policy. Manufacturers and wholesalers who seek to follow a policy of selective distribution have a number of problems to solve before it can be placed in effect. The principal ones relate to the cost of

serving different classes of buyers and those who buy in varying quantities. It is thus necessary to analyze distributive expenses in order to know the costs of selling under varying conditions. When this is done it is often found that, in some lines, only those buyers who purchase in original packages are profitable for wholesalers. In some cases the minimum point may be a dozen or a hundred packages or a certain volume in dollars. In other cases, study may disclose that it is not profitable to sell to certain entire classes of buyers.

Distribution cost analyses give distributors or manufacturers a definite idea as to how large an average order must be to justify servicing an account on a profitable basis. They may also disclose that certain classes of customers should be omitted from the sales plan. Yet it is not always feasible to restrict calls to profitable accounts. Sometimes new accounts must be cultivated at a loss for an initial period, with the hope that they will ultimately develop into profitable outlets. Many manufacturers feel that although some classes of customers are not profitable when measured by direct selling costs, the volume which they contribute is an essential part of the entire production plan of the factory, and therefore a greater loss might be incurred were this portion of the sales volume eliminated. It also depends upon prevailing economic conditions. Selective distribution is favored in a sellers' market or when competition compels strict attention to economy of operation.

Service Policies and Policies of Limited Distribution. Policies with respect to installation and repair services have an important bearing upon the degree to which it is feasible or desirable to limit distribution to exclusive or selected outlets. In the marketing of major appliances, the maintenance of adequate consumer service has always been an important problem related to distribution channel questions. Traditionally, service has been supplied by the franchised appliance dealer who, in typical situations, maintains a separate repair department employing from one to three or four persons. For many years service was an important patronage motive among consumers. Manufacturers tended to limit the distribution of major appliances largely to dealers who could provide a strong personal selling organization and satisfactory service facilities. In recent years there has been a great increase in the market for such appliances, substantial enlargement in the production capacity in the industry, and more aggressive competition among major manufacturers. Consumers are more aware of brand names. They tend to rely less upon the reputation of the store in which they buy and more upon their attitude toward the manufacturer's line as created by his advertising program and as derived from hearsay information among consumer associates. Under such conditions, the sale of appliances by retailing organizations without service facilities has become much more common.

The consumer, nevertheless, demands some kinds of service after sale. Often this has been provided only with great reluctance by regular dealers in cases where they did not make the original sale. Such dealers, moreover, have found it difficult to keep pace with technological progress as related to service problems in the industry. Substantial investments in capital are required for shop equipment to service properly television sets, freezers, ranges, and home laundry equipment, all of which are manufactured with increasingly complex automatic features or attachments. It is difficult to realize a profitable return on the investment in such equipment unless a large and regular volume of service business is developed and is also well managed.

Because of the growing importance of sales of appliances through discount houses and other dealers who may not provide services, and because of consumer dissatisfaction with the type of service provided by some smaller dealers without properly trained personnel or with inadequate equipment, a number of manufacturers have established central service organizations in major metropolitan areas. General Electric Company and Westinghouse Electric Corporation, for example, have provided central service facilities of their own or those managed by their wholesale distributors in a large number of metropolitan areas with over 100,000 population. Some of these facilities have as many as 100 service employees and may do as much service work as the aggregate of 100 or more independent dealers operating small-scale service shops. Obviously, only a large metropolitan area will support such a centralized service arrangement. In small market areas, service is still handled almost wholly by dealers who must necessarily be selected with a view to their ability to render needed installation and repair service.

Maintenance of a central service organization in a large city obviously tends to insure satisfactory servicing of appliances at probably lower costs. In addition, it reduces the need for confining distribution to carefully selected and decidedly limited numbers of outlets. A manufacturer's line of products that is substantially presold through aggressive advertising and other types of sales promotion may thus be placed in a much larger number of diverse types of outlets, approaching a more general or broadly selective method of distribution.

Legal Implications. Applications of exclusive agency or selective distribution policies pose several questions as to legality under the antitrust laws. One relates to the right of a manufacturer to prohibit a dealer from handling competitive products, a second has to do with the right to confine a distributor's sales to a defined territory, a third has to do with the right to force a dealer to carry a full line, and a fourth is concerned with the right to refuse to sell to a dealer who may desire to purchase from another manufacturer.

Exclusive Dealing. The first question is governed by Section 3 of the Clayton Antitrust Act of 1914 which provides, in part, as follows:

> It shall be unlawful for any person engaged in commerce to lease or make a sale or contract for sale of goods . . . on the condition, agreement, or understanding that the lessee or purchaser thereof shall not use or deal in the goods . . . of a competitor of the lessor or seller . . . where the effect of such lease, sale, or contract . . . may be to substantially lessen competition or tend to create a monopoly in any line of commerce.

After the enactment of this law, the courts have consistently condemned contracts between manufacturers and dealers which excluded the sale of competitive goods by the latter when the volume of the manufacturer's sales was a significant proportion of the total volume for the type of product in question, or when the effect was to exclude competitors from a substantial part of a market.

An important case in point is that of the Standard Oil Company of California, ruled upon by the U. S. Supreme Court in June of 1949.[4] It was shown that the company's sales of petroleum products constituted 23 per cent of the total in a group of "western" states of which sales by company-owned stations represented 6.8 per cent, sales by independent stations with exclusive agency contracts accounted for 6.7 per cent, and sales to industrial users constituted the remainder. Operators of 5,937 independent stations had signed exclusive agency contracts which required the dealers to purchase all of their requirements of one or more products from the company. The court ruled the contracts illegal because "competition has been foreclosed in a substantial share of the line of commerce affected," and further, that "Standard's use of the contracts creates just such a potential clog on competition as it was the purpose of Section 3 to remove wherever, were it to become actual, it would impede a substantial amount of competitive activity."

Another important illustrative case is that of Dictograph Products, Inc., ruled upon by the Supreme Court in 1955.[5] In an industry in which there were about 1,000 retail dealers for hearing aids, Dictograph had exclusive dealing contracts with 220 of them. These contracts contained provisions for mutual termination, but with the requirement that the distributor shall not engage in the hearing aid business in the same sales area for one year if he becomes unwilling to continue the sale of Dictograph hearing aids exclusively. The court upheld the Federal Trade Commission in the ruling that these agreements tended to foreclose a substantial portion of the market to competitors and denied competitive opportunities to Dictograph dealers.

[4] *Standard Oil Company of California and Standard Stations, Inc., v. United States* 337 U.S. 293, 69 S.Ct. 1051 (1948 and 1949).

[5] *Dictograph Products, Inc., v. FTC,* 217 F.2d 821, CA-2 (1954); *Certiorari* denied (U.S. Sup. Ct. 5–23–55).

A substantial volume of business was affected and, it was ruled, there was a tendency to substantially lessen competition in violation of Section 3 of the Clayton Act.

On the other hand, in a number of cases it has been held that contracts involving small or insignificant proportions of the business in a particular line do not come within the scope of this provision. For example, in a case involving a manufacturer who sold about one per cent of the national production of oleomargarine and who made contracts with wholesalers that prohibited them from handling competing brands, and where some 20 other manufacturers had similar contracts and the largest producers did not use exclusive contracts, it was held that the contracts did not have an actual or potential effect to substantially lessen competition.[6] There is, however, no hard and fast rule that may be applied to determine in advance the legality of such a proposed exclusive dealing policy. The question depends upon the volume of business involved, the practices of competitors, and other considerations in a particular industry or line of trade that may be considered by the Federal Trade Commission or by the courts in order to evaluate the effects of such agreements upon the actual or potential amount of competitive activity.

Exclusion features are perfectly legal when they are not related to competition. For example, the court upheld the right of oil companies to prohibit the sale of competing brands of gasoline in pumps and storage equipment supplied to the dealer by the manufacturer. It was ruled that the purpose of this agreement was not to restrict competition, but to prevent the confusion of the gasoline of the contracting oil companies with competing products and substitution, without knowledge by the ultimate consumer, of one brand for another.[7]

Right to Confine a Dealer's Sales Territorially. As early as 1916, it was well established that manufacturers have the legal right to sell through one dealer in a given territory.[8] Both state courts and Federal Trade Commission rulings have held that once a manufacturer designates an exclusive dealer in a given territory he may require the dealer not to sell his products outside of the territory assigned, and that such agreements are not per se in violation of the Sherman Antitrust Act, the Clayton Act, or state antitrust legislation.[9]

They become illegal, however, in cases where it can be shown that they have been used in such a manner that the effect was or tends to restrain

[6] *B. S. Pearsall Butter Co. v. Federal Trade Commission,* 292 Fed. 720, reversing F.T.C. Dkt. 550 (CCA-7, 1923).

[7] *Federal Trade Commission v. Sinclair Refining Co. et al.,* 261 U.S. 463 (1923).

[8] Federal Trade Commission Conference Rulings, Nos. 6, 15, 18, 20, 21, and 45 (1916); see also *Coca-Cola Co. v. J. G. Butler & Sons,* 229 Fed. 224 (1916).

[9] See, for example, *Thomas v. Blaylock* (Okla. Sup. Ct. 1940), 93 Okla. 587; also Federal Trade Commission Conference Ruling No. 13 (1916).

competition or to monopolize commerce in the commodity. In Department of Justice cases brought in recent years against exclusive territorial distributor systems, all have involved two factors: (1) their use by very large or leading manufacturers and (2) government allegations that the exclusive territorial arrangement was part of an attempt to monopolize, illegally restrain competition, or fix resale prices.[10] A number of such cases have been settled by consent decree. In one illustrative case, the Philco Corporation was enjoined from engaging in a number of so-called restrictive practices including entering into or enforcing any contract, agreement, or understanding "limiting or restricting, directly or indirectly, the persons to whom or the territory within which any wholesale distributor or retail dealer may choose to sell Philco products." It was clearly specified, however, that Philco had the right "to designate geographical areas in which such distributors shall respectively be primarily responsible for wholesaling Philco products and to terminate the franchise of distributors who do not adequately represent Philco and promote the sale of all Philco products in areas so designated as their primary responsibility."[11]

Full-Line Forcing. Requirements that a retailer or wholesaler handle a full line of a manufacturer's goods is not an illegal practice, as long as there is no requirement that the dealer shall not handle competitive products. To illustrate, in one important case brought under the Clayton Act, the Government contended that the company required each of its dealers to handle the full line of its farm machinery as a condition of receiving the contract to handle any of its products. It was asserted that this practice tended to exclude the dealer as an outlet for competitive lines of machinery. The court pointed out that "merely because a dealer handles one full line he is not disabled from handling another full line. In any event, a mutual arrangement between the farm machinery manufacturer and its dealer that it is for the best interest of both for the latter to handle a full line of the manufacturer's output, *without any restriction imposed upon the dealer,* is not violative of any law."[12] There is an inference in this ruling and in other cases that a policy of full-line forcing which had the effect of excluding competitors from doing business with the dealers involved would be illegal, provided a substantial share of commerce in the commodity was involved.

Right to Refuse to Sell. A number of cases have been brought before the courts by the Federal Trade Commission and the U. S. Department of Justice, alleging that refusal to sell to dealers who desire to purchase con-

[10] Cf. *Report of the Attorney General's National Committee to Study the Antitrust Laws* (Washington, D.C.: Government Printing Office, 1955), p. 29.

[11] *United States v. Philco Corporation,* U.S. District Court, Eastern District of Pennsylvania, Civil Action No. 18216, filed July 13, 1956.

[12] *United States v. J. I. Case Company,* 101 F. Supp. 856 (1951).

stitutes a violation of the Sherman Act which prohibits contracts, combinations, or conspiracies in restraint of trade or monopolies or attempts to monopolize trade or commerce. The guiding principle in such cases is that stated in the famous Colgate case, decided by the United States Supreme Court in 1919, and in which the court ruled that the Sherman Act "does not restrict the long recognized right of a trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal. And, of course, he may announce in advance the circumstances under which he will refuse to deal."[13]

In a more recent case, a wholesale distributor brought suit against the Ronson Art Metal Works, Inc., for alleged violations of the Clayton Act, because of Ronson's refusal to continue to take orders from the wholesaler. Ronson had written to the wholesaler, in part, as follows: "At the present time we are reducing our distribution in most sections of the country and in your market area we find that we are very well covered with distribution by other distributors. We therefore regret that we shall be unable to ship any further Ronson merchandise to you. This move is consistent with our current policy of reducing our distributors in all territories where we already have adequate coverage." The court ruled that Ronson had the right to do business with whom it pleased; that, as a private trader in interstate commerce, it could refuse to sell its merchandise to anyone, and by so doing it would in no way violate the antitrust laws.[14]

The right to refuse to sell may not, however, be used as a matter of policy to attain illegal or monopolistic ends. A manufacturer may not refuse to sell to a dealer *solely* because the dealer refuses to enter into a price-fixing agreement, unless the agreement is legal under resale price maintenance legislation,[15] as discussed in Chapter 34. Vertical price maintenance agreements or understandings which do not come within the scope of the so-called Fair Trade laws are illegal *per se*, regardless of the reasonableness of the price which may be set. In the historically significant Eastman Kodak case, the Supreme Court branded as an attempt to monopolize the discontinuance of photo supplies to a competitor who had previously resisted Kodak's attempts to buy him out in a plan for monopoly control.[16] Much more recently, the Supreme Court similarly condemned a newspaper's policy of turning down advertisers who utilized a competing radio station, as part of a pattern of "bold, relentless, and predatory commercial behavior" designed to stifle competition in local communication media.[17]

[13] *United States v. Colgate & Co.*, 250 U.S. 300 (1919).

[14] *Z. T. Naifeh, d.b.a. Sooner Sales Company v. Ronson Art Metal Works, Inc.*, 117 F. Supp. 690 (1953).

[15] *United States v. Bausch & Lomb Optical Company et al.*, 321 U.S. 707 (1944).

[16] *Eastman Kodak Co. v. Southern Photo Materials Co.*, 273 U.S. 359 (1927).

[17] *Lorain Journal Co. v. United States*, 342 U.S. 143 (1951).

LEASING AS A DISTRIBUTION POLICY

Nature of Leasing Arrangements. Under the lease method of marketing, the manufacturer or distributor gives possession of equipment or other articles to the customer. The manufacturer, commonly designated as the lessor, retains title and receives remuneration in the form of lease or rental payments made by the customer who is the lessee. Such a marketing policy is similar in many respects to that used in connection with instalment selling under the conditional sales agreement. There is a fundamental distinction, however, in that under leasing there is usually no intention of ever passing title to the customer. Exceptions are sometimes encountered in leasing contracts in which it is provided that rental payments may be applied against a specified purchase price, on an instalment sale basis, if the lessee decides at a later date to make an outright purchase rather than continue the leasing arrangement.

Common Uses. In several industries, leasing is an extensively used distribution policy. Much of the machinery used in shoe, glass container, and textile manufacturing is distributed in this manner as are also many kinds of industrial trucks and conveyors for materials handling, container-filling machinery, and various types of special purpose machinery used for riveting, sawing, or welding. Many of the more complex types of business machines and tabulating equipment have been leased under a service plan that affords valuable advisory, training, and maintenance aids for the user's executive and other employees. In the transportation field, leasing is common in the case of rolling stock for railroads, trucks for intercity freight haulers and local users, tires for bus companies, and automobiles for executives and salesmen. Many items of major construction equipment are so distributed. Manufacturers of supplies and of consumer goods have in some cases expanded their markets and have secured exclusive patronage or preferable point-of-sale display positions by leasing equipment in conjunction with the sale of the basic product. Even in dealing with ultimate consumers, renting or leasing is important for such products as floor sanders, paint sprays, automobile trailers, and other items of fairly high unit value used only irregularly or periodically.

Principles Governing Leasing.[18] Leasing policies have been in use for a sufficient period of time and under such a variety of circumstances that it

[18] Undoubtedly the most comprehensive study of leasing as a method of marketing is that made under the supervision of one of the co-authors by Francis A. Babione, entitled "Marketing Equipment by Leasing," an unpublished doctoral dissertation available in the library of The Ohio State University, 1949. For a summary of the study, see Francis A. Babione, "Marketing Equipment by Leasing," *The Journal of Marketing*, October, 1950, pp. 205–11. See also, Frank K. Griesinger, "Pros and Cons of Leasing Equipment," *Harvard Business Review*, March–April, 1955, pp. 75–89; and "Leasing: Sales Maker in 1956," *Printers' Ink*, September 30, 1955, pp. 21–23.

has been possible to formulate a number of principles which govern the adoption of such a policy and which indicate the rather limited conditions under which it may be employed advantageously.

A fundamental principle is that leasing facilitates the securing of a fair profit return from a limited market. There are a number of kinds of highly technical and very costly production equipment for which the number of potential customers does not exceed a dozen or so. Engineering and tooling costs in such cases may best be recovered by charging a royalty or rental fee. In this manner some part of any production cost savings realized by the user may be returned to the manufacturer of the equipment. The major alternative would be to fix a price so high that the product might be out of reach of some of the few available customers.

A related factor is that leasing makes possible the distribution of equipment to firms with limited financial resources. Payments are often smaller than would be necessary in an instalment-purchase plan, and the user has the additional advantage of not incurring a credit obligation which may impair his standing with customary suppliers or sources of cash loans. Under the conditions of very tight business credit supply that prevailed throughout 1955 and 1956, leasing proved to be an attractive means by which many companies were able to obtain the use of modern materials handling equipment and manufacturing machinery

Leasing is most readily applied where the need for equipment is seasonal or intermittent. There are undoubtedly numerous opportunities for further expansion of markets under these conditions. Very often equipment is leased for temporary use at the wholesale distributor level rather than directly by the manufacturers. Planning a distribution program and financing is, however, often the responsibility of the manufacturer. The renting of costly tools and other such items to home owners suggests that many retail stores have an opportunity of building good will and at the same time profiting from rental income.

Legal Limitations to Leasing. In contrast to outright sale, leasing enables the lessor to impose a number of restrictions upon the use of his product. Most of the contract provisions cover the basic privileges and obligations of both parties, but there is often a possibility that some of the limitations may be in violation of the antitrust laws. Under Section 3 of the Clayton Act, as explained in a preceding section, it is illegal to lease commodities on the condition that the lessee shall not use machinery or supplies offered by a competitor, where the effect may be substantially to lessen competition or tend to create a monopoly. As further explained in connection with the cases cited in the discussion of exclusive dealing, legality depends not upon precise objective criteria, but upon the facts of a particular case, and whether these are interpreted by the courts as having *a substantial effect upon com-*

petition. Illustrative is the case of the Thomson Mfg. Co. This firm, along with its principal competitor, followed the practice of leasing rivet setting machines in combination with rivet sales. For a small rental fee, the lessee was provided with a costly machine, under the condition that all rivets be purchased from the machine owner. It was shown that the rivets were priced about 10 per cent higher than in the open market, this differential compensating the manufacturer for the use of the machine and the maintenance services that were also provided. Evidence of an adverse effect upon competition was presented by the Federal Trade Commission in that rivet manufacturers who did not provide machines had been largely excluded from this field. The court ruled that "the practical effect is to preclude the use of supplies of a competitor and thus substantially lessen competition."[19]

Questions and Problems

1. Define or explain each of the following terms:
   a) general distribution
   b) exclusive agent
   c) selective distribution
   d) central service agency
   e) exclusive dealing
   f) full-line forcing
2. Briefly explain the principal types of points usually or commonly included in exclusive agency contracts.
3. From the viewpoint of manufacturers, explain the principal advantages and disadvantages of an exclusive agency policy. What are the main advantages and limitations of such a policy from the viewpoint of middlemen?
4. State the principal conditions under which exclusive agency plans of distribution are commonly used.
5. What are the main similarities and differences between exclusive agency policies and selective distribution policies?
6. How is distributon cost analysis related to selective distribution policies?
7. What effect must be established before a violation of Section 3 of the Clayton Act can be proved?
8. Under what conditions is leasing most desirable as a distribution policy?
9. What kinds of products are most commonly distributed by means of leasing?
10. Examine the yellow page sections of a metropolitan area telephone directory and list the various kinds of items which are advertised therein as being available on a rental or lease basis.
11. Explain the probable attitude of the courts or the Federal Trade Commission in each of the following situations:
    a) The XYZ Company is the country's largest producer of oil filters for installation on automotive engines. Except for sales made directly to automobile manufacturers, filter installations and replacement cartridges are sold through automotive accessory wholesalers. The company's sales

[19] *Thomson Mfg. Co. v. Federal Trade Commission*, 150 F.2d 952 (CCA-1, 1945). Certiorari denied (U.S. Sup. Ct., 1945), 326 U.S. 776.

amount to about 20 per cent of the total for this kind of business. The exclusive agency method is used among wholesalers, who are required to sell only in their defined territory and who must sign contracts not to sell any similar competing products. A wholesale distributor maintains that these contract provisions are illegal.

b) The Ajax Baking Company distributes bread, rolls, cake, and pastry items to retail stores. In order to get point-of-sale advertising and good display space, the company leases display equipment to grocers for a very nominal sum but requires grocers to sign an agreement that no competing products will be sold on this equipment. A retail grocer violates this agreement but seeks to prevent withdrawal of the equipment of the baker on the ground that the exclusive feature is in restraint of trade.

c) A manufacturer of fountain pens has discontinued selling to certain dealers because they did not give the promotional effort to the line which the manufacturer desired from his customers. Several such dealers have protested, claiming that the manufacturer does not have the legal right to refuse to sell to them.

d) A manufacturer of a branded toothpaste product which is similar to numerous other competing products has refused to sell to a chain store organization because it is generally known that this company is a price cutter that has not maintained retail prices established by other manufacturers.

12. The Williams Company is a manufacturer of home laundry equipment. It distributes its product through franchised dealers all over the country. Except for very large cities, it has been the policy of the company to limit representation in any community to one dealer by an exclusive agency arrangement. The general sales manager proposes in an executive meeting that the company change its policy by permitting a number of dealers to operate in all but the smallest cities. He contends that one agency cannot work heavily populated areas intensively. Furthermore, washing machines are today more of a shopping good than formerly because of the many producers now in the field and the increased emphasis on price competition.

The vice-president takes issue with the proposal. He points out that the appliance business is still largely a matter of "going out after sales," and this can be better accomplished by one large exclusive agency in an area. The proposal would lead to competitive bidding or price-cutting among such local representatives and this is undesirable, especially as the company tries to maintain uniformity of prices within divisional areas. Again, if department stores and other nonspecialized retailers are allowed to carry the line, they will not give it proper emphasis or aggressive sales promotion. Finally, such a change will antagonize existing agencies which have spent much time, money, and effort in building good will and creating demand for the Williams product.

Evaluate the above proposal in the light of the arguments advanced. If you were present at this discussion, could you point out any other factors which should be considered?

13. The General Manufacturing Company produces a quality line of men's shirts, ties, pajamas, and related articles. The line is sold by the sales force directly to retailers. The number of outlets has been limited to one depart-

ment store and one men's clothing store in each city, except that in cities of over 100,000 population this number might be increased if suitable stores could be found. The company advertises extensively in national magazines and has given dealers limited allowances for local newspaper advertising. The above policies enabled the company to achieve a large initial volume of sales, but for the past several years sales seem to have become stabilized, even though the advertising appropriation has been materially increased. The profit margin on the present business is satisfactory. The president of the company is anxious to increase the volume of sales, and believes that the line should be sold to any retailer willing to handle it. The sales manager is content to go along on the present basis and is afraid of the ill will which would be created if the existing exclusive agency system were terminated. As a market analyst, state your recommendation and justify it.

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PRICES, PRICING, AND PRICE BEHAVIOR

Prices and the price-making process are subjects that have occupied the serious attention of economists and economic analysts for many generations. Numerous treatises have been written on their various phases as well as on the general subject, especially from a theoretical approach. In this chapter it is intended to devote principal attention to the meaning of the term "price," to the price-making process in theory and in practice, and to the general pattern of actual price behavior, including the matter of price flexibility and price rigidity. The price policies employed in setting prices by individual vendors, other than those of price-fixing, are the subject of discussion in the chapter immediately following. A third chapter is devoted to a consideration of price-fixing and price control.

Prices and Marketing. The subject of prices has many facets. Marketing administrators and informed students of marketing should have knowledge pertaining to a number of price and pricing questions which, for convenience, are outlined as follows:

1. Meaning of price
2. Importance of prices
3. Price determination in theory and in practice
4. Price and discount policies
5. Price behavior and price patterns at different distributive levels and in different commodity or industrial groups
6. Nature and implications of price flexibility and price rigidity
7. Price trends of a long-term nature and current movements as reflected by appropriate price indexes
8. Price change
9. Price regulation
10. Price control in time of emergency and in time of peace

Meaning of the Term "Price." Any good that has the capacity to satisfy a human want is said to possess *utility*. The power of such utility or of the good possessing it to command other goods in normal and regular exchange is its *value*. Such value, expressed in terms of a standard monetary unit as the dollar, is the *price* of the good. Thus, price is the money value of a commodity or service which emerges after a market transaction has been completed. In a competitive economy, prices are the grist that markets grind.

Economists generally distinguish between two types of prices—the *actual or market price* and the *normal price*. The actual or *market* price is the price that exists in the market at any given place or time or in different places and at different times. It is the price which the seller actually receives for his product and which the buyer actually pays for it. Some leading economists consider "market price" as the price during a period within which the supply of the commodity is fixed. In the case of farm crops, for example, the supply may be known and fixed for a given season. In such a case, the seller of the product must sell it at the market price which then prevails at his point of supply. His only alternatives are to ship the product to another market or to hold it off the market until some future time when better prices are anticipated.

The *normal* price is altogether a theoretical concept and is presumed to be the price toward which the market price tends, although the two may at no time coincide. The normal price, in turn, may be of two species: short run and long run. The former emerges when the seller has a definitely fixed size of plant, and the industry has a fixed number of firms; while the long-run normal price is that ruling over a period long enough to permit entrepreneurs to build plants of any size or to divest themselves of plants entirely. Generally, the economist's concern with price is what may be labeled "the long-run normal price" and not so much with everyday market prices. This is not difficult to understand, for, *theoretically*, it is the long-run normal price which will tend to bring upon the market just that supply for which buyers will be willing to pay enough to cover the costs of producing and marketing that commodity and yield a reasonable net profit. A producer cannot continue permanently to sell his product below cost. He would certainly have to cease operations, due to exhaustion of financial resources caused by continuous losses. This would curtail the supply, which would gradually cause prices to advance sufficiently to yield a profit to the firms remaining in business. Consequently, the lower limit of price for any commodity would, in the long run, be fixed by the producing and marketing costs of the marginal units.[1] The upper limit of the normal price tends to

[1] Marginal producers or marketing enterprisers are those who would first withdraw their offerings if the prices were lowered. They are not necessarily the least efficient concerns. In fact, they may be the most efficient. At any rate, they are in such a strategic position that, by withholding their increment of supply from the market, they can exert a decisive influence upon the market price.

be determined, in the long run, by what buyers are willing to pay for an existing supply.

Both upper and lower limits supposedly operate over a period of time. Market prices, on the other hand, are the prices that prevail from day to day and may, at least temporarily, greatly deviate from the *normal* price limits. When quantities of highly perishable fruits and vegetables much in excess of local requirements are received in a given market, prices are depressed much below cost. When a manufacturer or retailer accumulates an excessive inventory, it may become necessary for him to dispose of the surplus at reduced prices which may not cover actual costs. Conversely, under other conditions the price may be substantially higher than cost. When new styles of garments prove to be popular, the price at which the garments are sold is considerably above cost, for under these circumstances producers and distributors charge all that the traffic will bear. A similar situation obtains when certain brands have become well established and the demand for them is widespread and constant, for this condition virtually marks the product as a semi-monopoly.

Importance of Prices. Prices paid for goods and services play a dominant part in our economic life. In actual practice, they help to determine the *money* wages paid for labor and the *real* wages received by labor, i.e., the amounts of goods and services which the money wages will buy. For consumers generally, prices have a significant bearing on their standard of living. For the seller of goods they are of utmost importance. A major aim of all marketing and merchandising is to sell goods at a price that will cover the cost of production or purchase, together with all operating expenses, and leave a reasonable net profit to the entrepreneur. Thus prices are directly related to net profit, and net profit—the principal motivating force of business—depends largely upon the price policies adopted and upon the price-making process as a whole. In the absence of net profit, our competitive system cannot function within the framework of a democracy such as ours, much to the detriment of industrial and social progress as conceived for this nation within that framework.

In the long run, prices serve to regulate economic activity. When prices become relatively low in a given industry because of increased supply in that industry or decreased demand for its products, profits tend to decline, vanish, or to be replaced by losses. Under such circumstances, capital, land, labor, and enterprise are shifted from that industry to others that are more remunerative. By the same token, when prices are relatively high in a given field of economic activity, capital, land, labor, and enterprise are attracted to it and the supply of its products is thereby enhanced. In this manner, in a competitive economy, prices tend to determine the allocation of economic resources to the most effective uses.

Price Determination in Theory[2]

In order to understand the economist's explanation of the price-making process, to which he often refers as the market-type analysis, one must be familiar with the hypotheses used and the general framework of his discussion. Commonly, he starts with an analysis of pure or perfect competition and the prices that emerge under such conditions; then he considers the several forms of monopoly and their role in price determination; and finally, he deals with what he generally terms the forms of imperfect or monopolistic competition (which in reality represent what should probably be termed "normal" or "workable" competition) and the functioning of the price-making process in that environment.

Nature of and Requirements for Pure or Perfect Competition.[3] Probably one of the best generic definitions of this kind of competition, from the sellers' viewpoint, is the following: "Competition is rivalry in selling goods, in which each selling unit normally seeks maximum net revenue, under conditions such that the price or prices each seller can charge are effectively limited by the free option of the buyer to buy from a rival seller or sellers of what we think of as 'the same' product, necessitating an effort of each seller to equal or exceed the attractiveness of the others' offerings to a sufficient number of buyers to accomplish the end in view."[4] In order to have pure or perfect competition, the following conditions or prerequisites are essential:

1. A *large number of small sellers,* so that no one seller's action will have any appreciable effect on the *supply* of the product and consequently its price.
2. A *large number of small buyers,* so that the action of any one buyer will have no appreciable effect on the *demand* for the product and on the resultant price.
3. The *product must be completely identical, standardized, or thoroughly homogeneous,* so that it would make no difference whether it is obtained from one seller or another.
4. There must be *complete and accurate knowledge of conditions of supply and demand,* and all buyers and sellers must be in possession of such knowledge.

[2] Because of the extensive treatment given to theoretical price determination in almost all general economics textbooks, only a brief résumé is presented at this point.

[3] Sometimes an attempt is made to distinguish between *pure* and *perfect* competition, but in such case the term "perfect competition" is limited in scope to exclude the requirement of a completely standardized product. It is felt that this represents a distinction without a difference and that to make such a distinction it becomes necessary to redefine the term "perfect" in order to narrow its scope. Indeed, what can be purer than perfect or more perfect than pure? In this discussion the two terms are, therefore, used synonymously.

[4] J. M. Clark, "Toward a Concept of Workable Competition," *American Economic Review,* June, 1940, p. 243.

5. All buyers must buy and all sellers must offer to sell *under exactly the same conditions* with regard to credit terms, delivery, guaranties, etc.
6. *Every buyer and every seller must act in a rational or sensible way* and must in no way be affected by any consideration other than price. In a system of this kind there must be no room for complicated motives or for human frailties; there is room only for the "economic man."
7. There must be a perfectly elastic supply of the factors of production. In order to make for such elasticity of supply, there must be free and easy entry into the business of new sellers or of an expansion in plant on the part of existing sellers. This, of course, also implies free and easy exit from business if a curtailment in supply is warranted.

Market Price Under Pure or Perfect Competition. If it were possible to achieve these conditions, *market prices would be established at a point where the existing demand for a given commodity would clear the market of the available supply.*

Demand may be defined as want coupled with ability to pay. Generally, more units of a given commodity will be purchased at a lower price and fewer units at a higher price. By supply is meant a schedule of the amounts which will be offered by producers as the price varies. Producers will make available larger supplies whenever price is greater than cost of production, and conversely, they will shift their efforts to other activities when the price is not sufficient to cover the cost of production.

Because no individual seller has any effect upon total supply and no single buyer has any effect upon total demand, prices are beyond the control of individual buyers or sellers. If the market price is currently below the cost of production for a given seller, he must take a loss; and if this continues he must ultimately go out of business. If the same situation confronts a number of sellers, the number dropping out of the industry may have some effect upon the total supply that will be made available at a given price. If supply decreases relative to demand, buyers are forced to bid up the price, and in this way upward revisions of price are accomplished. Such an upward revision may again encourage greater production.

Similarly, if the price of a commodity is too high for a given buyer, he must pay the high price or go without the article. When he decides to go without it, demand is decreased only by a negligible amount; but if the same situation confronts a number of buyers, total demand is measurably affected. When demand declines relative to supply, under conditions of pure competition, prices will drop in order to clear the market. As prices decline, more buyers enter the market and their activity prevents the price from going lower than necessary to balance supply and demand.

Thus, market price is the price at which the amount of the commodity that buyers are willing to take and the amount that sellers offer are in *equilibrium*. It would result in perfect balance, as no one who is willing to

buy at the going price would fail to find a seller, and no one who is willing to sell would fail to find a buyer. Price would move in one direction or another and so adjust itself through the play of demand and supply forces to bring about this equilibrium. This is known as the *free price system.*

Since it is impossible for any buyer or seller to affect his total revenue by a change in price (over which he has no control), the only manner in which a firm's total revenue may be increased is by handling more units of a product. Furthermore, under such competition, no individual seller or buyer would advertise, for advertising would merely add to his cost. No benefit would be derived by the advertiser because the product he buys or sells would be no different from that bought or sold by his competitors.

Pure or Perfect Competition Is Mythical. From the very listing of the conditions and prerequisites for pure or perfect competition it would appear extremely doubtful whether such conditions could ever be met collectively in any important part of our economy. It is, therefore, equally doubtful whether such competition ever existed. Even in farm products like wheat where the conditions most closely approximate those of pure or perfect competition, there are marketing cooperatives (which reduce the number of sellers and thereby exert a restraining influence on supply) and only a few large buyers in some markets. A leading student of the subject admits the impracticability of the assumptions made by the analytical economist who tries to explain price in such an economy in actual, precise terms. Such an economist must either "include in his list assumptions which bring the problem close to the real problems, but which make it insoluble by the technique at his command, or to confine the problems within the limits which make it soluble but to hide the assumptions which bound it (if he is too honest to omit them altogether) in a dusty corner of the footnotes where he hopes that no one will notice them."[5] That is why a leading contemporary economist stated: "With this had come the realization that 'perfect competition' does not and cannot exist and has presumably never existed. . . . What we have left is an unreal or ideal standard which may serve as *a starting point of analysis and a norm with which to compare actual competitive conditions.*"[6]

Market Price Under Monopoly. *Monopoly* obtains when a single seller has complete control over the entire output of a given product or service, but no complete monopoly is really possible except in the absence of reasonably close substitutes. The nearest approach to such complete monopolies is to be found in the field of public utilities, and at one time probably one or two industrial concerns may have qualified for such classification.

[5] Joan Robinson, *The Economics of Imperfect Competition* (London: Macmillan & Co., Ltd., 1936), p. 2.

[6] J. M. Clark, *op. cit.*, p. 2. (Italics supplied.)

There are, however, several other forms of so-called monopoly. There are cases where two sellers have control over the entire supply of a product and thus establish a *duopoly*. There are even more of the *oligopoly* species, where the supply is controlled by a very small number of firms selling on quoted prices and anticipating one another's reactions.

The several forms of monopoly may also be found on the buying side of the market and are in that case of the *monopsonistic* type. A single buyer of a given product in a certain area may exploit his advantage by paying a lower price than otherwise justified. Such a *monopsony* condition may take the form of price discrimination, so that one buyer may receive a better price than another buyer of the identical commodity. When only two companies purchase all the fresh milk produced in a given area and there is no practical competition from other buyers, a *duopsony* exists in that area. In fact, very frequently a monopsonistic situation arises not so much from the action of the buyer as from the preference accorded him by the seller or sellers.

All cases of monopoly or monopsony are characterized by *nonprice competition*. In case of monopoly, the seller exercises full control over the price of his product. This does not necessarily mean that the price he will set will be the highest or even a high price, for he will attempt to set the price at a point which will maximize his profits. Obviously, then, if he sets the price so high as to discourage all or most of the potential customers, he will defeat his own end. On the other hand, if he sets the price extremely low, there may be no net profit at all, or the net profit per unit of product may be so small that the total amount of such revenue will be much less than if he sold fewer units at a higher price. His task, therefore, is to discover that price which, multiplied by the number of units he expects to sell at that price, *will yield the maximum total net profit.*

The consequence of a search for maximum total profits is that the monopolist will control both output and price entirely to his advantage, if he acts merely as an economic man. The first major problem is the determination of demand, i.e., a schedule of the quantities that may be sold at each of various alternative prices. Second, probable costs of production at each different level of output must be estimated. Profits are maximized by producing at the level at which there is the greatest difference between total production costs and total expected revenue. Thus if the demand for the product is inelastic, the greatest total revenue is obtained by selling a smaller number of units, each at a relatively high price. If, however, the demand for his product is elastic, more units will be sold at a relatively low price. Theoretically, in either case, *the monopolist will produce and sell until his marginal cost equals his marginal revenue,* i.e., until the last unit added to his supply costs as much as the price at which that product is selling. Furthermore, advertising and other sales promotional effort may be very

profitable for the monopolist, especially if the demand for his product is elastic.

Normal or Workable Competition. By and large, however, our economic world today and for many generations past has been characterized by significant deviations from the assumptions underlying perfect or pure competition, nor has it been dominated, except in public utilities subject to government regulation and in a few rare examples in industry and business, by strict monopoly. That is why our competitive system has been labeled by various economic analysts as one of imperfect, monopolistic, modified, intermediate, workable, or hybrid competition. In this connection the term "imperfect competition" has been used most commonly. To such characterization of our competitive system, there are serious objections. In the first place, it implies that perfection in competition is possible, which is contrary to any reasonable expectation. Second, it connotes an ethical appraisal of our system, surrounded by an undesirable odor, for which there is little basis in fact. Third, it implies that price competition is the only kind of competition that matters.

Inasmuch as this kind of competition pervades our entire economic system and the instances of perfect competition on the one hand and real monopoly on the other are totally lacking or relatively few and rare, and in view of the objections just stated to the label "imperfect" competition, it would seem best to designate the so-called imperfect competition as "normal" or "workable" competition. It is the kind of competition that is prevalent and workable in everyday economic life of the people. It is the kind of competition that *is* normal and is universally regarded so by the public. The major reasons for the prevalence of this normal or workable competition are obvious from its principal characteristics which are as follows:

1. Most products on the market are differentiated in varying degrees. A relatively small number of them are completely homogeneous and thoroughly standardized. There may be many grades of the same commodity, and even in the same grade the quality of the commodity may vary, depending upon whether it is in the upper, lower, or middle part of that grade. Leaf tobacco is a good illustration.
2. There is much brand differentiation. Similar products may be and are sold under different brand names. Even though the actual or real difference may be ever so slight or entirely nonexistent, if the buyer *thinks* that the product bearing a certain label is different, it *is* different as far as that buyer is concerned, and he may derive from that fact enormous "psychic" value.
3. There are differences in the conditions under which a commodity may be bought or sold. A buyer may be willing to pay a higher price for a given grade of product to one source of supply that is in closer proximity than to another more distant source. The preferred source of supply may

also be deemed to be more reliable, more pleasant to deal with, may extend more liberal credit accommodations, may have a more pleasant environment in which to shop, and may make adjustments more satisfactorily.

4. In the case of many products there is the style element which differentiates one product from all the others.
5. Advertising may influence buyers to patronize one source of supply in preference to others.
6. Installation, maintenance, and repair services may differ considerably and thus prove to be a strong factor in attracting patronage.

Market Price Under Workable Competition. In a competitive economy, i.e., one in which a substantial degree of, or normal, competition exists, market price is, by and large, a resultant of the interplay of supply and demand factors in a relatively free market, particularly the demand factors.

There is no question but that costs play a significant part in price determination. This is particularly true of commodities that are standardized and the units of which are interchangeable, as in the case of grain, steel, and many other raw materials and semi-manufactures. Under these circumstances, cost affects the selling price profoundly through its influence upon the quantity produced. But when brand and style differentiation become important elements, a different situation results. Each producer and distributor of such goods may exert tremendous power over current and future demand. Not only may existing *expressed* demand be directed along a given channel, but demand in general may be influenced considerably by the efforts of vendors to arouse, through aggressive merchandising methods, *latent* buying motives and to intensify desires of potential purchasers.

In all cases, whether or not the product is highly differentiated, the elasticity of demand, shifts in demand, and the action of competitors have an important bearing in determining the individual prices of commodities. At best, the relation between selling price and cost is elastic, varying with the business cycle, with the efficiency of the seller, and with the character and maturity or market saturation of the product. This must not be confused with the economist's cost-price analysis in which he concerns himself chiefly with the long-run normal price previously discussed, and invariably refers to alternative or opportunity cost which has to do with the next most profitable use or combination of uses of the factors of production.

ACTUAL PRICE DETERMINATION[7]

Price determination in practice is indeed a complex matter. An entire volume could easily be filled with examples illustrating different methods

[7] For a much more detailed treatment of this subject, see the many interesting illustrations in Jules Backman, *Price Practices and Price Policies—Selected Writings* (New York: The Ronald Press Co., 1953); also in Joel Dean, *Managerial Economics* Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1951), especially chaps. vii-ix.

used by various companies in setting actual selling prices. For the most part, however, the numerous specific methods may be classified into two main groups or approaches. One of these is to establish prices primarily on the basis of cost considerations. The other is to determine prices largely with reference to the market or to competitive circumstances. Both of these approaches are discussed in the following paragraphs, and several variations of each of them are explained or illustrated.

The Cost-Plus Approach. One general method is for a seller of a product to establish his prices *on the basis of costs* of manufacturing or of purchasing for resale, plus whatever markup or margins are deemed necessary to cover relevant overhead or marketing expenses and net profits. This approach is used under a wide variety of circumstances as when: price competition is not particularly intense; the product is highly differentiated in terms of marketing or engineering services provided in connection with its sale; the seller has a distinct location advantage, with respect to transportation costs to point of use, as compared with competitors; management is highly influenced by the desideratum of covering all economic costs in each sales transaction; and competitors have similar costs and follow similar pricing practices. The application of the cost-plus approach varies somewhat depending upon whether it is being used by a manufacturer or by a middleman and whether total costs or only variable costs are being covered by a specific pricing process.

Application by Manufacturers. Various important studies of business practice in this country and abroad have indicated that cost-plus pricing is the most common method used by manufacturing firms.[8] By cost is usually meant the cost of manufacturing a unit of product, including not only variable costs, such as raw materials and direct labor, but also fixed expense such as depreciation on equipment and plant and supervisory expenses. Just what figure is used for manufacturing cost varies from one situation to another. Some manufacturers use their actual costs for the most recent accounting period, including direct wages, material, and whatever loading charge for overhead was necessary at the current rate of output. In industries where the volume of output may vary considerably from one period to another, standard or so-called "normal" costs may be determined on the basis of average annual rates of output. In certain instances, the cost may be a forecasted figure, based on the volume of output expected in a future period. If the product is new, the cost may be altogether conjectural, being derived from engineering estimates and historical experience with costs of similar or related items.

[8] Studies of this type are cited by Joel Dean, *op. cit.*, p. 445.

The amount of markup to be added to cost also varies widely, but is likely to be rather definitized within a given firm and sometimes within a group of firms constituting a particular industry classification. In general, the markup is a factor deemed adequate to cover the expense of general corporate administration and marketing and to allow for a reasonable net profit realization.

If the product is to be sold through middlemen to final industrial users or to ultimate consumers, the manufacturer must allow also for the margins of middlemen in arriving at final or list prices. This may be illustrated by the case of a manufacturer of a new home furnishings product who has estimated that total manufacturing costs will amount to $94 per unit at an anticipated output of 200,000 units annually. General administrative costs and marketing costs, including freight prepaid to distributors, amount to about 25 per cent of sales on somewhat similar items. It is desired to realize a net profit of 10 per cent of sales. A margin of 35 per cent of sales is therefore necessary. Manufacturing costs must not exceed 65 per cent of the manufacturer's selling price, which is calculated to be $144 62 ($94 divided by 65 and multiplied by 100). Wholesale distributors handling this product are to be granted a discount of 20 per cent from their selling prices to compensate them for the cost of performing their marketing services and to provide them with a net profit. A distributor's cost is therefore 80 per cent of his selling price which would amount to $180.78 ($144.62 divided by 80 and multiplied by 100). Retailers handling the product are to be allowed a discount of 35 per cent from the final selling price, so their cost must not exceed about 65 per cent of the list price. The retail or list price would then be $278.12 ($180.78 divided by 65 and multiplied by 100). This might be modified slightly upward or downward, to arrive at an odd price (e.g., $279 or $277.50), which is presumed to have more psychological appeal to the consumer.

Application by Middlemen. Selling prices of wholesalers and retailers are determined in part by the resale price maintenance policies of their suppliers, in part by competitive circumstances, and in part by managerial judgment within the organization. When the middleman determines his own selling prices without being influenced by heavy competitive pressure, this is often done by applying an average markup per cent. Such markups consist of three ingredients: the normal cost of rendering the marketing services provided by the middleman; the anticipated markdowns or stock shortages on the merchandise handled; and the net profit goal of the organization. In an empirical study of the pricing practices of wholesalers in the hardware, dry goods, and drug trades, it was found that a markup of 33 per cent of the invoice cost of goods purchased (25 per cent of selling price) was en-

countered much more frequently than any other markup percentage.[9] Markups of 33 per cent of selling price (50 per cent of merchandise cost) have been traditional on the less competitive items in the retail hardware and retail drug trade. In the merchandising of women's ready-to-wear apparel in department and specialty stores, typical initial markups have been 40 per cent of retail and in the retail furniture trade they have been 50 per cent of initial retail prices.

Such average markup percentages, whether applied by retailers or by wholesalers, are usually considerably higher than the average gross margin of profits actually realized by such firms. This happens because many items, especially those selling in largest volume, are priced much below the average markup figure as dictated by competitive pressures; and many others are sold after deducting or experiencing markdowns, losses on trade-in allowances, and special discounts or other price concessions from initial selling prices.

Rate-of-Return Pricing. A concept that has received increasing attention is that of pricing to realize some predetermined rate of return on capital investment. The application of this specific approach to cost-plus pricing in an automobile manufacturing company was widely publicized as early as 1924.[10] In the distributive trades, this approach has been popularized in the 1950's especially in connection with the operation of large volume, high turnover, discount-house types of stores.[11] The general principle of rate-of-return pricing may be stated as follows: *the greater the number of times that the total capital investment is turned over in sales volume, the smaller is the net profit per cent to sales volume that is required to realize a given per cent of return on capital investment.* Many manufacturing and merchandising organizations have attempted to realize a satisfactory profit return on capital investment by an approach to pricing which results in relatively low prices, in comparison with historical or competitive standards, and in an unusually large volume of sales with high turnover. When high turnover is actually achieved, it permits relatively low expenses of operation resulting from the optimum utilization of fixed facilities. In 1956, the General Electric Company used this approach in making substantial revisions of its price

[9] Aaron John Alton, *Formation of Prices by Wholesalers in Specified Lines of Business*, an unpublished doctoral dissertation carried out under the supervision of two of the authors and deposited in the library of The Ohio State University, 1956; Tables 4, 9, and 13.

[10] Donaldson Brown, "Rate of Return Pricing in Relation to Financial Control," *Management and Administration*, February, 1924, pp. 195–98; March, 1924, pp. 283–86; and April, 1924, pp. 417–22.

[11] See, for example, Arnold Corbin, "The Economics of Discount Selling," in John W. Wingate and Arnold Corbin, *Changing Patterns in Retailing* (Homewood, Ill., Richard D. Irwin, Inc., 1956), pp. 126 ff.; also, Edward M. Barnet, "Showdown in the Market Place," *Harvard Business Review*, July-August, 1956, pp. 85 ff.

structure for small appliances. For example, prices of its vacuum cleaner were modified as follows:[12]

	Prior Price or Margin	*New Price or Margin*	*Per Cent Reduction*
Factory selling price to wholesale distributor	$33.93	$27.23	20.0
Distributor's margin	10.49	6.49	38.1
Distributor's selling price to retailer	44.42	33.72	24.1
Retailer's margin	25.53	16.23	36.5
Retailer's price to consumer	69.95	49.95	28.6

These drastic revisions were established after careful consideration was given to the effect of presumed larger sales volume at lower prices upon costs of manufacturing and costs of performing marketing services within the manufacturing company and throughout its channels of distribution. The expectation was that the manufacturer and its distributors and dealers could realize greater dollar profits and a better profit return on investment by selling in larger volume at a lower markup. This approach is most likely to be acceptable to businessmen when there is very good reason to believe that such a change in pricing can produce a *much larger* volume of sales without proportional increases in costs. It can be done most readily when there presently exists considerable unused or surplus capacity in terms of physical facilities or administrative overhead expense items.

Pricing on the Basis of Variable or Incremental Costs. In the foregoing paragraphs, attention has been devoted to pricing on the basis of costs, but with regard to full costs or, more specifically, to the sum of the variable and the fixed costs involved in the manufacture and marketing of a unit of product. In some instances, products are priced on the basis of the variable costs involved rather than full costs. This approach is used most widely under special circumstances as when a business is depressed, is selling outside of its normal market, or has considerable unused capacity. For example, in what would otherwise be an idle season, a shoe manufacturing company may gladly accept a large order from a chain of price-appeal stores on a basis which barely covers the cost of materials and direct factory labor. Such an order may help to keep the plant's labor force intact, avoid costly shutdowns, and also make a small contribution to overhead expense which would be incurred, even if the order were not accepted.

A similar approach is followed by retailers who occasionally negotiate prices with consumers. A furniture retailer, for example, may decide to take a sudden markdown before letting a customer who wishes to make a large purchase walk out of the store. If the price, after granting the concession, more than covers the cost of the merchandise plus an adequate markup

[12] Adapted from basic data in "GE's New Appliance Marketing Strategy," *Tide,* November 9, 1956, pp. 13–17. It will be noted that percentage-wise the wholesaler and retailer made the greatest contribution to the consumer's lower price.

to cover also the direct costs of sales compensation, warehousing handling, and delivery, the merchant is better off to realize some contribution to store overhead expense than to miss the sale. Such reasoning assumes, of course, that the merchant has some assured source of so-called "regular price" business adequate in volume to cover the total of his expenses of operation and that the practice of negotiating prices on some sales to some customers does not lead all customers to expect to buy on the basis of prices which merely cover variable costs. In other words, this reasoning is based on the assumption that the sales so obtained are what may be called "plus business" and will not affect unfavorably the seller's regular volume.

Market or Competitive Approach. Many vendors do not have much of a problem with respect to price determination. They find that they operate within a trade or industry where prices are intensely competitive or are established by custom, tradition, or price leaders. Selling prices are, in such cases, a given factor for the firm. The problem is largely one of adjusting selling effort, marketing services, product features, and costs to the going selling price. As in the case of the "cost-plus approach," this method also has a number of specific variations.

Adaptation of the Product to Established Prices. This approach is sometimes used by a manufacturer in designing a product to be offered on the market at a prevailing competitive price or at some established retail price line. A manufacturer may decide that in view of the existing conditions he can sell a given number of units of his product at a certain price. Starting with that price, he deducts from it the various margins required by the retailers and wholesalers through whom the product is distributed, transportation expenses, and his own cost of marketing and advertising the product. The remainder represents what he can afford to spend for the production of the article. He then puts his engineers and others to work to draw up the specifications that will produce the desired product at the predetermined cost figure. This method of price determination is most feasible when production costs can be definitely controlled and hazards minimized. For example, a toy manufacturer may wish to produce a child's kitchen tool set for Christmas business to retail at the popular price of \$1.98. If the product is to be sold through department stores, variety chains, and automotive accessory chains, a markup of about 40 per cent must be allowed for retailers. The manufacturer's selling price could not be more than about 60 per cent of retail or \$1.19 per unit. If the manufacturer's administrative costs, marketing expense, and net profit requirement aggregate about 30 per cent, then the allowable cost of manufacturing would be about 83 cents (\$1.19 x .70). Product design personnel are expected to come up with an attractively packaged item with sales appeal that can be manufactured within this limit.

Competitive Circumstances. An important specific price-determining factor in almost all cases is the nature and extent of competition. Sometimes it may be of paramount importance. In the case of actual or alleged monopolies, competition is of least significance; but even here it enters as a factor, for there usually is a possibility of substituting other products. Cellophane, for example, must compete in end uses with a wide variety of other transparent and nontransparent packaging materials.

Brand development has modified the competitive situation in many cases. The establishment of a reputation for a certain brand sometimes removes the product from the purely competitive realm and gives it a semimonopolistic quality. A higher price may then be charged for the commodity because of its brand than otherwise would have been possible. Aggressive brand-name advertising is very common, however, in industries in which price competition is extremely important among all agencies on each level in the distribution channel. In the field of household detergents and soap products, for example, the consumer is price conscious because of the frequency of purchase and the large relative importance of such expenditures in total annual household spending. Each manufacturer must be competitive with every maker of a similar product. All wholesalers must meet the prices charged for each brand by other wholesalers who provide similar services for customers. All supermarkets in a given trading area are likely to have identical competitive prices on such products on any given day.

The effect of varying competitive pressures upon different lines of merchandise handled by a single marketing institution may be illustrated by an example from the supermarket industry. In an extensive study of the gross margins of profit realized by such institutions, it was found that the total gross margin for the grocery department during the period of the study amounted to 16.6 per cent of sales. Marked variations by product groups within this department were found, however, and margins were especially low on items that were highly advertised and purchased most frequently. Even on these items the variation was quite substantial as indicated by the following: cigarettes, 5.8 per cent; sugar, 6.2 per cent; soaps, 8.4 per cent; canned and powdered milk, 8.5 per cent; baby foods, 9.8 per cent; beverages, 10.4 per cent; and soups, 11.6 per cent.[13] In all these categories competition has forced retail selling prices markedly below the average cost of doing business in supermarkets. Obviously, such stores can operate profitably only because of their ability to realize considerably higher margins on products which are not so intensely competitive.

Price Leadership. A single firm sometimes takes the initiative in instituting price changes and others follow, selling at, above, or below the competitor's prices, depending upon the policy in operation. Usually the smaller

[13] "Facts in Grocery Distribution," 1956 Edition, *Progressive Grocer,* p. 18.

firms, whether retailers, wholesalers, or manufacturers, follow such a leader rather closely in adopting a similar price or one which enables them to compete successfully. Each store, for example, watches its competitors with great care, many of them employing shoppers to visit competing concerns and make comparisons as to prices, qualities, and services. In the manufacturing field, also, recognized leaders are followed. A few examples are afforded by the Standard Oil Company of New Jersey, the American Sugar Refining Company, and the United States Steel Corporation, whose prices are closely watched by the less powerful competitors. In practically every market there are one or more firms which are recognized as leaders in the trade and whose prices are used as a basis for the determination of the prices to be charged for competing goods. Prices announced in catalogs by a leader in an industry are usually watched closely by the other members of the industry who then determine their prices accordingly.

What Traffic Will Bear. Prices frequently are a direct reflection of the amount which it is believed purchasers will pay. Through past experience and a thorough knowledge of his clientele, it should not be difficult for a retailer, wholesaler, or manufacturer to determine the price range at which certain goods can best be sold. This method, sometimes referred to as the "eye-value" or "estimating" method of price determination, applies principally to style goods and is based on previous experience, knowledge of own clientele and their reactions, prices charged by competitors, advice from sellers, and the judgment of competent sales clerks, department managers, and shoppers employed by the firm under consideration. It is not uncommon for a millinery store, for example, to sell at widely different prices, a group of hats purchased at the same figure, merely because of some slight variations of individual hats of the group in color, pattern, style, shape, or design. Men's clothing and women's ready-to-wear in particular fall in this category. A policy of this sort appears to be justifiable, for in the handling of certain goods it is the only means of securing ample reward for merchandising ability, initiative, and ingenuity. Moreover, extra profits on the popular styles tend to offset losses on merchandise that may prove relatively unpopular or on sales made toward the end of the season.

A modification of this method of pricing is that of "price lining," i.e., producing goods to fit into certain price lines. For example, a dress manufacturer may wish to appeal to retailers who offer dresses at $19.95. The price on his merchandise is automatically determined by that desire, and his price to such retailers must then be $19.95 less the margin required by them. Similarly, the retailer who operates within a certain price line has his prices automatically determined by such a policy.

Customary or Convenient Prices. Prices and markups on specific items are often varied from the normal or average in order to sell at customary

or convenient prices. When a price has prevailed for some time, it is taken for granted both by buyer and seller alike. Coca-Cola, various brands of chewing gum, and numerous other articles have been selling at the same prices for a considerable period of time regardless of business cycles and tremendous fluctuations in the prices of raw materials, labor, and capital entering into their production. These prices are both customary and convenient from the standpoint of payment and making change.

Once prices have become established as customary, it may be extremely hazardous to undertake upward changes. If wholesale prices rise high enough to threaten the retailer's margin, the latter in some cases prefers to discontinue the line rather than raise the price to a new level. Sometimes the price unit remains the same, but an adjustment is made in quality or quantity. Prices of candy bars, for example, have been maintained at customary levels over periods of fluctuating cost conditions by varying the weight of the product.

Overlapping of Basic Approaches. When a firm uses some form of either one of the two basic approaches to price determination (i.e., cost-plus or market and competitive conditions), it does not exclude consideration of the other. Differences are largely a matter of emphasis. A manufacturer who prices primarily on the basis of costs must give some attention to competitive conditions and, indeed, the prices of his rivals may cause him to modify the price arrived at on the basis of cost factors. Similarly, as indicated in several of the preceding examples, one who prices competitively does not disregard costs. His starting point may be a competitive market price, but he studies costs carefully, attempting to adjust them to prevailing conditions.

General Pattern of Price Behavior

Despite numerous attempts at careful analysis, relatively little is known of the behavior of prices of the thousands of individual commodities that enter into everyday commerce. Some idea can be had, however, from such studies of the *general* pattern of these prices. In general, retail prices are fixed ultimately by the reaction of consumers and their wherewithal. Ultimate consumers are final judges in the matter, and they necessarily establish upper limits to prices at all preceding points in the chain of distribution. In other words, prices quoted by wholesalers to the retail merchants depend largely upon the prices at which those goods can be resold to the consumer. Manufacturers, in turn, in selling to wholesalers, must make quotations so that the latter may resell to the trade at a profit. This does not mean that all prices fluctuate in exactly the same way at all times or that the prices of all commodities are affected in the same manner.

Wholesale Market Prices. Numerous fluctuations in price are quite common in commodities that are free from monopolistic control and the prices of which are not stabilized or administered by producer, combination, or association. These fluctuations are generally caused by changes in supply and demand conditions. They are usually more frequent but less violent in major wholesale markets, than at production points or in retail stores, for such markets are sensitive and highly organized. Operators in the wholesale markets are the first recipients of market information relating to conditions of supply and demand affecting the products in which they are interested. Furthermore, all wholesale dealers in a given market are likely to receive such information simultaneously. Dealing in large quantities and operating on a relatively small margin of profit, a slight change in price may sometimes spell success or failure and certainly may make the difference between profit and loss; hence, it is essential that they receive all relevant market news as promptly as possible, and that they develop skill in interpreting it. All these conditions tend to make the wholesale price, especially in the city markets, the controlling price for both producers' and retailers' prices. This is especially true when commodities are standardized, market knowledge is available, and buyers and sellers are concentrated, as in the marketing of wheat, where, as a result of the factors enumerated above, a uniform market price in a single market is established. But where styles, brands, and patterns enter into the situation or where goods cannot be standardized, competition is still very real and preferences may well become the basis for some departure from prices of competitors.

Prices at Points of Production. Prices paid at the farm or factory generally follow wholesale market prices more closely than do retail prices. Transactions in the original producers' market involve large quantities, so that even minor fluctuations become significant. Then, again, it is usually the aim of purchasers in the producers' market to resell the goods, probably in some wholesale market. Consequently, it becomes important that prices in the latter market be followed closely. Fluctuations in prices are, however, less frequent in producers' markets but much more violent than in city wholesale markets, largely because of the lack of as complete an organization and as keen competition. Furthermore, manufacturers may sell direct to consumers or else produce branded and widely advertised goods on which the policy is to maintain prices. Again, the prices of certain commodities may become well established because of custom or convenience, thereby obviating any necessity for frequent price fluctuations. In other producers' markets, as at many country points where farm products are first marketed, there may be a lack of keen competition for reasons indicated in Chapter 18. While at some points prices change at least once a day, there are numerous growers' markets in which prices are established for a week at a time.

Over a period of time, particularly when reckoned in terms of cyclical fluctuations, some producers' prices undergo a more radical change than others. Prices of many manufactured industrial commodities are administered. Consequently, they change relatively little during slumps in general business or on the upward grade of the business cycle. Prices of agricultural products, on the other hand, drop precipitously in periods of depression and make an upward adjustment when conditions improve. Even in the field of manufactured products, prices of consumer goods follow cyclical movements more closely than do the prices of capital goods. It is generally believed that this latter type of price rigidity is largely a product of modern times, although one author who has analyzed price indexes for a period of a century dating from 1837, claims that prices are generally less rigid than in earlier days.[14] One may seriously question, however, the quality of the statistical data available for the earlier years, since even the data on prices for recent years have many important weaknesses.

Retail Prices. Prices in the retail markets fluctuate less than in any other type of market. For this several reasons may be cited. In the first place, as customary or convenient prices may prevail in certain lines, variations can be made only from one customary or convenient price to another, and these variations are often so great that minor fluctuations in the wholesale price must be disregarded. Second, retail prices cannot be varied with every change in wholesale prices. Fluctuations in the latter are so numerous that practical difficulties would be encountered by a retailer and his clerks in re-marking the goods and in keeping track of all such changes from day to day. Chaos and confusion would invariably result, for it would be impossible for retailers to remember the current prices of the numerous items carried. Furthermore, consumers are likely to resent such practice. They much prefer a reasonable degree of price stability to frequent changes which they may find embarrassing and annoying. Consumers do not follow the market closely and are consequently unfamiliar with slight changes in the wholesale price.

Again, retailers' margins are usually wide enough to absorb all unfavorable minor price fluctuations. Favorable changes, on the other hand, cannot conveniently be passed along unless they are substantial, for changes in retail prices are seldom made in fractional amounts. On a rising market, the retailer often hesitates to raise his prices for fear of creating an undesirable impression on his trade. On a falling market, he likewise hesitates to sell his high-cost inventory at lower prices. This has often proved a grave error, for it is usually better, if the market is definitely declining, to dispose of all high-cost merchandise as soon as possible and take the loss at once. This

[14] Rufus S. Tucker, "The Reasons for Price Rigidity," *American Economic Review,* March, 1938.

makes possible the purchase of lower-priced goods on which a profit is more probable.

Eggs afford an excellent illustration of the relationship between retail, wholesale, and producers' prices. Wholesale prices are quoted on the basis of carload quantities of 14,400 dozen, with minimum price variations of 1/20 of a cent per dozen or $7.20 per car. As may be observed from published wholesale market quotations, prices change daily and, in some seasons of the year, much more frequently than that. Prices paid to producers at country points fluctuate less often but more violently, in conformity with the general trend of the wholesale market. Prices to consumers, however, may not change for a week or more at a time, but whenever such changes are effected, they usually amount to from 1 to 5 cents per dozen.

Price Flexibility and Price Rigidity. These are two terms which are in common use among economists and statisticians and simply refer to different ways in which prices respond to changes in market conditions. This is especially noticeable during periods of violent economic change, as in times of stress culminating in a depression or in times of relative scarcity of commodities culminating in a period of high prosperity. During such periods prices of some commodities move freely and widely, while other prices change infrequently and very narrowly. Prices of the first type are designated as *flexible* or sensitive, while those of the second type are known as *rigid,* inflexible, stable, or insensitive.[15] In between the two extremes, there are many gradations of price flexibility or rigidity. Those that are relatively, though not completely, rigid are often called *sticky* prices, especially where the price adjustments are not only slow to respond to changing conditions of supply and demand but are also made periodically and infrequently.

The importance of this distinction stems from the fact that prices are said to be most flexible when sellers enjoy very little discretion in their determination, for they are governed entirely by competitive conditions and by the law of supply and demand. On the other hand, prices are deemed most rigid where the seller has the highest latitude in their determination, either as a result of a monopolistic situation or through collusive restraints of trade. It is on this assumption that price rigidity has been regarded by government and certain other economists with suspicion and as a sure sign of price control by monopolistic devices.[16]

By the same token, price flexibility has been regarded favorably, for ups and downs are presumed to retard or quicken demand, to accelerate or

[15] For a detailed discussion of this subject, see T.N.E.C. Monograph No. 1, *Price Behavior and Business Policy* (Washington, D.C.: Government Printing Office, 1940); see also Ernest M. Doblin, "Some Aspects of Price Flexibility," *Review of Economic Statistics,* Vol. XXII, 1940, pp. 183–89; and T. C. Schilling, "The Dynamics of Price Flexibility," *American Economic Review,* September, 1949, pp. 911–22.

[16] Those who approve of price rigidity usually refer to the phenomenon as that of price *stability.*

arrest supply, and to maintain harmony between the flow of goods and effective demand for them. That is why it has been accepted by many as the unfailing sign of competition at work.

The position just outlined with regard to price stability or rigidity on the one hand and price flexibility on the other, must be criticized on several scores. First, flexible price as a regulator of demand does not have a perfect medium in which to work. It is subject to the check of custom, and it does not measure off the supply of goods to the effective wants of consumers. Second, price stability or steadiness is more common than constant fluctuations when commodities are sold openly on a market price basis. This is true of agricultural products as well as of manufactured goods. Examination of the peacetime "Wholesale Prices" published by the Bureau of Labor Statistics reveals that such products as cotton, hay, fluid milk, seeds, and wool sell at the same wholesale prices in a given market for months at a time and frequently for an entire season. Such is also the case with many manufactured products that are known to be highly competitive in the sense of normal or workable competition previously discussed, as illustrated by condensed milk, bread, rice, baked beans, sugar, cornstarch, many textiles, paper, and bar iron. Third, it depends to a large extent at what level the price rigidity is being maintained. If a rigid or stable price is maintained at a very low level, it may be the result of extremely keen and almost cutthroat competition rather than a result of a monopolistic device. It would thus seem that a mere "jitterbugging" of prices per se has little meaning, and the same is true of price rigidity in itself and without reference to the level and to the effect upon the public. The matter of price rigidity or flexibility must, therefore, be considered merely as a starting point in any investigation of the existence or absence of competition.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   - *a*) value
   - *b*) utility
   - *c*) price
   - *d*) perfect competition
   - *e*) oligopoly
   - *f*) market price
   - *g*) normal price
   - *h*) monopolist
   - *i*) monopsonist
   - *j*) normal competition
   - *k*) rate-of-return pricing
   - *l*) price flexibility
   - *m*) price rigidity
2. Indicate the relationship of price to value, wages, net profit, general economic activity.
3. A certain legislator is proposing a bill which would provide large sums of money for purposes of financing an existing antitrust agency. He maintains that we must have free and pure competition in our economy and feels that his proposed measure would make this possible. Evaluate the desirability

and the possibility of such a proposal, pointing out the conditions which must be met before pure and perfect competition can exist.

4. What should a marketing administrator know about the subject of prices?

5. Is there any purpose in distinguishing between pure and perfect competition? If such competition does not now exist and probably never has existed, as pointed out in the text, why deal with that type of competition?

6. The competition that prevails today in the United States has often been characterized as imperfect competition. Do you agree with this characterization? Explain. If not, how would you characterize it?

7. What is meant by cost-plus pricing? Explain several specific variations of this general approach.

8. What is meant by pricing on the basis of market or competition? Explain several specific variations of this general approach.

9. In general, which of the two over-all methods of price determination should be followed—cost of production or the competitive market situation? If you were the buyer of millinery for a department store, what *specific* method of price determination would you follow? Would the same method be applicable to pricing groceries? Explain.

10. What relationship, if any, exists between wholesale prices, retail prices, and producers' prices (in the case of agricultural products)? Which of these prices are the most sensitive and which are the least sensitive? Which of these prices are most violent in fluctuation?

11. Is price stability or rigidity to be deplored or desired from the standpoint of society? Explain.

12. Go to the library and obtain a copy of the *Statistical Abstract of the United States*. From this source, determine what kinds of price statistics are available and, from the footnotes to the various tables, find the original source for current and more detailed price data. From the information thus obtained, prepare an outline of the series of data and their sources that would be needed in making a study of price behavior and price patterns:
    a) At different levels:
        (1) In retail markets
        (2) In major wholesale markets
        (3) At points of production
    b) In different parts of the economy:
        (1) Agricultural vs. manufactured goods
        (2) Durable vs. nondurable goods
        (3) Consumer vs. industrial goods
        (4) Different industries

13. A chewing gum manufacturer was faced with rising production costs on his product. Experience had shown him that it would be impossible to cover these added costs by raised prices. Various methods to lower costs were suggested as follows:
    a) The wrapping and packaging might be slighted for economy's sake
    b) The amount of gum per stick could be cut down
    c) Quality could be reduced

Why did the manufacturer find it impossible to raise prices? Which of the suggested methods of cutting costs seems best?

14. A manufacturer of an altogether new type of electrical appliance is planning to put this product on the market in the next several months. Engineering estimates indicate that manufacturing costs will amount to $14.80 per unit at an annual output of 500,000 units. Because the product has some highly desirable features which cannot be quickly adapted by competitors, it is believed that this quantity can easily be sold at almost any price that appears reasonable to the consumer. The manufacturer desires to obtain a gross margin of 40 per cent to cover the cost of general administration, selling, advertising, transportation to distributors, and to provide a reasonable net profit. Wholesale distributors will be granted discounts amounting to 15 per cent of their selling prices and retailers will be given discounts of 32.5 per cent from final list prices. If the cost-plus approach to pricing is followed, what would be the retail price of this item?

15. A regional flour miller is planning to bring out a ready-mixed pie crust product. Several other manufacturers have similar products on the market and most of these sell at 19 cents in most supermarkets. The company feels that it must be directly competitive with such established products if it enters the field. The product will be sold in part to wholesalers and in part to large direct-buying chain organizations. In either case, it is estimated that a margin of about 24 per cent of the retail price will be required to cover the costs of wholesale and retail distribution. The product will be sold f.o.b. mill. Freight will therefore be paid by wholesalers and food chains, and will become a part of their landed cost of goods purchased, which is computed before figuring gross margins at the distributive level. Actual freight costs will vary slightly from one buyer to another but are expected to amount to about 5 per cent of the landed cost at wholesaler or chain warehouses. The manufacturer sells to wholesalers and to food chains through food brokers who will receive a commission of 5 per cent on their sales. In addition, the manufacturer must have a margin of about 15 per cent to cover his administrative and marketing costs and to provide a net profit. If this product is to be introduced, what is the allowable manufacturing cost per unit of product?

33

PRICE AND DISCOUNT POLICIES

In setting the prices at which he is willing to sell his goods, a businessman may be governed by one or more policies directly relating to the matter. Among them are a large number that are more or less in common use, some of them more important socially than others, and some of them partaking of the nature of price fixing. This chapter presents a discussion of all significant price policies other than those dealing with delivered pricing or price fixing. The latter types of policies are reserved for treatment in the chapter that follows.

Odd Price Policy. One price policy in common use, especially in retailing, is the odd price policy. This policy has been widely adopted, despite inconvenience in making change and the necessity for the customer to linger until change is made. Some stores use odd figures on all merchandise carried, while others limit their use to certain departments, lines of goods, or to individual articles of a line.

A certain favorable psychological effect is secured, for odd figures present the idea of a bargain, as if the price were reduced to the last possible cent, although the impression of price reductions may be given by actually raising instead of lowering prices. It is said that more articles can be sold at 17 than at 14 cents, because the former suggests a reduction from 20 cents, while 14 cents suggests only a reduction from 15 cents. At any rate, odd figures help to attract attention to the matter of price. For this reason the policy has also been adopted by some manufacturers and wholesalers.

Odd prices that are one or two cents below the next highest even price point (e.g., 29, 49, 99, 2.98) are most common, as a matter of retail pricing practice, up to the $4.00 level. Beyond that point and up to $50, it is more common to express odd prices in terms of five-cent reductions from an even

price (e.g., $4.95, 10.95, 49.95).[1] The odd price idea is also applied to articles of considerable unit value, such as automobiles or house trailers, although odd endings are usually in dollars rather than in cents.

Lowest Price Policy. Some vendors follow a policy of underselling competitors. A notable historical example is the famous R. H. Macy & Company department store in New York. Over a number of generations, its policy has been to sell at less than the shopped price for comparable items. More recently, this policy has been used by various discount houses, especially Masters, Inc., and E. J. Korvette, Inc., both of which operate a number of establishments in eastern markets, and Polk Bros. of Chicago. This price policy is by no means confined to the field of retailing. In the wholesaling of goods, arrangements are frequently made whereby the vendor agrees to supply his customers with merchandise at or below the lowest price quoted by competitors, thus following the policy of "meet or beat" competitors' prices.

There are some manufacturers who believe in and follow a low or lowest price policy. Such a policy is most likely to succeed in markets in which there are considerable latent demands at lower prices, and the manufacturers most likely to do so are those with a relatively high physical efficiency. Such a policy tends to widen the market and to give the seller the opportunity of utilizing his facilities to best advantage.

There are definite limits, however, to what may be deemed desirably low prices for any period of time. Unless the reduction is a matter of competitive necessity, no businessman can be expected to reduce his prices materially in the face of a belief that he would not be compensated by sufficient increases in sales volume. Assuming a homogeneous product, the price of the product may be constant at a given time and no firm may be able to sell above the ruling price. No lower price, therefore, need be quoted in order to get the business. In fact, a further lowering of price may bring retaliatory action from competitors or at best may result in a permanent lowering of prices by all of them.

Stable Prices. A rather common policy is that of maintaining one or a limited number of selling prices which remain stable over a considerable period of time. In the shoe trade a number of manufacturers and retailers have adopted this method by following a *single price policy*. All shoes in a given store or of a given kind are marked, say, at $8.95, or perhaps $10.95. We have $5 or $10 millinery stores and numerous stores selling men's hats and clothes at definite fixed prices. A similar tendency may be observed in many other retail institutions which attempt to zone the prices of their goods so that the bulk of the merchandise will fall in a limited number of

[1] For the results of a detailed empirical investigation of this subject, see Harold J. Rudolph, "Pricing for Today's Market," *Printers' Ink*, May 29, 1954, p. 24.

price lines. They do not attempt to carry goods at all prices, but confine their attention largely to goods within certain price ranges, consisting of two or more established price lines, with only a sprinkling of goods below or above these or none at all.

Stable prices of this type have the advantage of attracting customers to stores, for they know exactly what the price will be. They possess the element of definiteness, are a constant advertisement, and tend to form valuable buying habits among customers. But the very definiteness of an established price or price range tends to limit the merchandising plans of a manufacturer or retailer and in a period of rising prices tends to reduce the range of products that can be handled at the established price or to lower the quality in order to maintain price stability. An habitual and established price cannot be disturbed, especially upward, without a corresponding disturbance in business. But it may occasionally be desirable to raise the limit due to a general and protracted rise in price levels.

One-Price vs. Varying Price Policy. A *one-price policy,* sometimes referred to as a policy of uniform selling prices, requires that the same price be quoted or charged to all customers who purchase goods under substantially similar conditions as regards place and time of purchase, terms of credit, quality, and quantity. Adoption of such a policy by no means prevents a vendor from changing prices as frequently as he deems desirable, provided that all customers who buy similar quantities under the same circumstances get the same price at any given time. Under a *varying price policy,* price concessions are made to favored customers or because of competition and the customer's superior bargaining ability. Concessions take the form of lower quotations, extra cash discounts, extra trade discounts, or exceptionally high quantity discounts.

Strict adherence to a one-price policy is characteristic of most retailing institutions. Retailers selling miscellaneous merchandise of low unit value and those dealing with large segments of the consuming public, such as major department store chains, have found such a policy indispensable. To be sure, many deviations from a one-price policy have always existed in retailing, especially among smaller stores and those dealing in merchandise of high unit value.[2] The use of varying price policies has, perhaps, increased more in post-World War II years, as automobiles, appliances, and durable home furnishings have tended to become of greater relative importance in the total consumption expenditures. The practice of negotiating prices has been resorted to by many orthodox retailers in attempts to meet price competition from discount houses. It has, furthermore, always been of considerable significance in the sale of items where "trade-ins" are cus-

[2] Many interesting deviations from the one-price system in retailing have been classified and described by Stanley C. Hollander, "The One-Price System—Fact or Fiction?" *Journal of Retailing,* Fall, 1955, pp. 127–44.

tomary and variations from established list prices can be disguised by greater or lesser trade-in allowances. There still are some other isolated cases of stores that depart occasionally from uniform selling price practice, especially when it becomes evident that a sale is slipping, although they ostensibly operate on a one-price basis.

In the wholesale trades, strict adherence to a one-price policy is not as common. In many cases the price for each sale is subject to negotiation. Salesmen are permitted to quote prices, within stipulated limits, that will enable them to meet competition. The results are necessarily arbitrary, depending largely upon the bargaining ability of salesmen and the shrewdness of individual customers. For various legal reasons, and because of certain disadvantages pointed out below, the trend in wholesaling has been away from varying price policies and in favor of one-price policies.

Disadvantages of a Varying Price Policy. A varying price policy may give rise to serious complications, as when one customer discovers that another has secured identical goods from the vendor at a lower price. A basis for serious friction is established, and much good will is lost as a consequence.

A second disadvantage is that the poorest and least desirable customers are sometimes the best bargainers, while good and progressive merchants devote their buying time to a consideration of quality, variety, style, and quantity of the merchandise they desire and leave the matter of price to the selling house in whose fair treatment they have full confidence. Similarly, some consumers may spend their time in selecting goods that will give them satisfaction rather than regarding price as of paramount importance. It appears to be unfair to penalize such customers merely because they are unwilling or unable to bargain, yet that is frequently the case in the absence of a one-price policy.

Furthermore, under a varying price policy, weak salesmen are apt to sell most of their goods at the minimum authorized price, thus reducing the profit upon their sales to an undesirable figure. A close examination of salesmen's records will reveal the fact that price-cutting on the part of individual salesmen is often the result of poor salesmanship. It will be shown that some salesmen chronically resort to the practice, while others having the same power seldom exercise it. Such a policy may therefore place a premium on poor salesmanship.

A further complication would arise from such a price policy in large retail establishments. It would be difficult indeed, if not impossible, to keep an accurate check on all salespeople employed by such concerns in order to prevent pilfering and other dishonest practices, and to maintain control over prices and markdowns. Finally, as noted below, a varying price policy is of questionable legality under the Robinson-Patman Act for firms engaged in interstate commerce.

Advantages of One Price. A one-price policy, on the other hand, when strictly adhered to, is fair to all customers. It does not penalize a poor bargainer and at the same time permits sales emphasis to be placed on the goods rather than on the price. This makes for more efficient buying and a better selection of merchandise, and thereby insures satisfaction and good will. It eliminates bickering, higgling, and browbeating, and consequently removes the stigma under which tradesmen of former ages generally labored. Sales are effected with considerable economy so long as price is taken for granted. It also saves considerable time on the part of both buyer and seller. One needs stretch his imagination but little to appreciate the time that would be consumed in the bargaining process in connection with each of the thousands of sales that are made daily in the larger retail institutions. Finally, a one-price policy is absolutely indispensable to all selling by mail, bargaining being too costly, cumbersome, and inconvenient under such circumstances.

Arguments for Varying Prices. Despite the advantages of a one-price policy, its universal adoption may not be hoped for in the near future. Many dealers still prefer to bargain. A varying price policy gives salesmen leeway to meet competition on a price basis. Slight changes in wholesale prices may, because of the large quantities involved and the small margins on which purchasers for resale or industrial consumption operate, mean a difference between profit or loss on the transaction. Moreover, wholesalers and manufacturers feel that they may be justified in charging a different price to certain customers because of differences in credit risks. Finally, there has been a feeling that buyers for resale or industrial use do not need the same degree of protection as do ultimate consumers, since the former have more knowledge of conditions of supply and demand and are thus in as good a position to bargain as are the vendors.

In spite of these arguments, the practice of varying prices has tended to decline because of the provision of the Robinson-Patman Act which prohibits discrimination in price between different purchasers of commodities of like grade and quality, where the effect may be "to substantially lessen competition." While the implications and effects of this provision are discussed in detail in Chapter 36, it is important to note in this connection that a seller who gives a lower price to one customer than to another who is in competition with the first must, under the law, be able to justify such action on one of two grounds. One is the ability to prove that the lower price in one case can be supported by factual evidence of lower costs associated with dealing with the customer who obtained the lower price, either because of larger quantities purchased by the customer who benefited from the discrimination or on account of differences in method of sale or delivery. Second, the discrimination may be justified if the seller can establish that it

was necessary for him to quote such a price in good faith to meet the competition of some other seller of comparable goods offered at such lower price. If neither of these conditions obtains, then the seller would likely be held in violation of the Robinson-Patman Act, thereby tending to force upon manufacturers and wholesalers a one-price policy if they are engaged in interstate commerce. It should also be noted that the receiver of the lower price that cannot be justified by the seller is also guilty of a violation of the law if the discrimination is received knowingly by him. It is very doubtful, however, if this legislation can ever be enforced to an extent that will eliminate varying price policies altogether. Furthermore, the second justification mentioned above occurs with sufficient frequency in wholesale trade to support the argument that varying price policies will be used for many years to come.

Trade Discounts vs. Net Prices. In a large number of lines, it is customary for manufacturers, wholesalers, and other wholesale vendors to quote prices to their customers in the form of list prices, from which one or more discounts are deducted before the actual selling price is determined. List prices are made considerably larger than the actual selling prices, reductions or discounts being determined by various factors. The general purpose of a trade discount is to compensate the distributors for the performance of their functions by providing a gross margin. A common method is to quote several trade discounts from the list price instead of quoting a single discount. An illustration of a list price with a string or chain of discounts is the following: \$5-30-10-5-2. The price that the customer pays for that article is \$5 less 30 per cent or \$1.50, less 10 per cent of the remainder or 35 cents, less 15¾ cents, less 6 cents, resulting in a net price of \$2.93¼.

The practice of granting trade discounts is not directly affected by the price discrimination provision of the Robinson-Patman Act. Such discounts, regardless of their number or magnitude, are perfectly legal so long as there is no prohibited discrimination among competing customers.

Reasons for Trade Discounts. The practice of quoting list prices subject to reductions in the form of trade discounts may be accounted for in four ways. First, many such vendors issue comprehensive and costly catalogs at infrequent intervals. When list prices instead of actual selling prices to the trade are printed, it is less difficult to indicate changes involving increases or decreases in prices of certain groups of articles by means of supplementary discount sheets. It is much more convenient to notify the salesmen and prospective customers that discounts on certain *groups* of commodities have been increased or decreased by a specified per cent than to give a long series of new actual selling prices on each of the articles affected.

In the second place, list prices may be used to indicate the prices at which the goods should be resold to other middlemen or consumers. They

thus serve as a suggestion that it is the desire of the vendor that prices be maintained on certain goods. This may be accomplished by limiting the trade discount on such items to a figure that will yield only a fair margin of profit to the average merchant. It is extremely difficult, however, to arrive at a discount that will yield a fair gross margin to the majority of purchasers and yet not be large enough to induce price-cutting. Moreover, if the discount is not adequate to cover the margin of the relatively inefficient concerns, it will result in a restricted market for the goods, as such dealers will refuse to stock the merchandise.

Then there is the possibility of using list prices as a means of resorting to a varying price policy. When list prices are quoted in a catalog a dealer must, if he wishes to find out the net price, secure, in addition to the catalog, the discount sheets which can more easily be kept in confidence by salesmen. Similarly, the practice makes it possible to hide prices from competitors.

Finally, when a retailer shows a customer the wholesaler's or manufacturer's catalog, as is often the case in the sale of certain goods such as floor coverings and furniture, for the selection of items not in stock, the customer does not see the net price paid by the dealer. In fact, the dealer may be able to sell below the list price, in which event the customer will feel that he has been accorded favored treatment.

Disadvantages. Trade discounts are disadvantageous from the buyer's standpoint because they do not permit direct comparison of prices quoted by different sellers, since tedious arithmetical calculations are often necessary to obtain net prices. These operations are equally difficult for sellers, except that many of them resort to the use of tables that have been worked out in advance. On the whole, net prices are much more convenient and less cumbersome than list prices with trade discounts.

Functional Discounts. A common practice of companies selling to more than one class of customers is price differentiation based on the status of the purchaser, which is usually determined by the level or plane of the production or distribution system on which the purchaser operates. For example, when a manufacturer distributes his products through both wholesalers and retailers, he generally adopts two distinct scales of prices. If he also sells direct to ultimate consumers, a triple scale of prices is likely to prevail. Again, there is the extreme case of the manufacturer who sells his product in part to other manufacturers for use in original equipment or for replacement in such equipment, in part to primary distributors who sell to wholesalers, in part to wholesalers who sell to retailers and servicemen, and in part direct to retailers and servicemen through his own sales branches. Under such circumstances, it would not be illogical for the manufacturer

to have four different scales of prices; in fact, this may be essential for continued success of such a distribution method. In the same way, when a wholesaler sells to both retailers and ultimate consumers, he generally maintains a separate set of prices for each type of clientele.

Under the circumstances described above it is common practice to quote prices by the use of discounts from list prices. When such discounts are given to classes of customers operating at the different levels of the production or distribution system (exclusive of ultimate consumers, but sometimes inclusive of business consumers), they are discounts to the trade and are known as *trade discounts* or as *functional discounts*. Such discounts are a traditional pricing technique by which suppliers compensate middlemen or others who act in that capacity for the performance of distributive services. Since such discounts prevail *regardless of the quantities* involved in a given transaction or in the aggregate volume of a customer's purchases over a period of time, they reflect, in one sense, rough approximations by the supplier of the economic advantage of dealing with certain classes of institutions that perform characteristic marketing functions;[3] but in a more real sense they are a measure of the margins that must be provided for such classes of institutions if they are to be used in the marketing process.

Trade discounts given to wholesalers and to others operating on the wholesale level of distribution are known as *functional discounts*, presumably because they are intended to compensate them for the performance of the essential wholesaling functions which would otherwise have to be performed by the manufacturer himself, if this alternative were available at all, and probably at much higher cost; for that reason emphasis is on functions as the *raison d'être* for the discounts. The same reasoning runs through all trade discounts as they are applied to the different levels or planes of operation in our economic system. Consequently, the amount or size of a trade discount given to retailers is governed by what margin such retailers require to enable them to perform their functions of retailing in the long run at a reasonable profit. Similarly, the size of the functional discount given to wholesalers must be governed by the margin required by the wholesalers to perform their wholesaling functions on a long-run basis.

Conceptually, then, price differentiation in the form of a functional discount is not directly or basically concerned with the quantity of the purchase. Although a retailer may buy amounts in individual shipments and over a period of time as large as, or even larger than, some wholesalers, nevertheless he cannot secure the same price advantages which are available to wholesalers. Unless a customer qualifies for the "jobber list" he is not entitled to the *functional* discount, regardless of quantity, although for each

[3] Cf. *Report of the Attorney General's National Committee to Study the Antitrust Laws* (Washington, D.C.: Government Printing Office, 1955), p. 202 ff.

class of customers there may also be a quantity discount to which he may be entitled by reason of a large purchase. To be sure, wholesalers tend to buy in larger quantities than the retailers whom they serve, but there are certain types of large-scale retailers who buy in equally large or in larger quantities and yet remain in the retailer classification to which the wholesalers' functional discount does not apply. By the same token, it follows that from an economic viewpoint a functional discount need not be justified by economies effected by the seller but should be based upon the requirements of the class of customers, i.e., wholesalers, to cover the cost of performing their essential functions and yield a reasonable net profit on the services rendered by them to the manufacturer and to society. If wholesalers are an essential link in the channel of distribution, their continued existence as a marketing institution must be assured by an adequate margin provided by a price differential whether it be in the form of a functional discount or as a quoted lower net price than that given to retailers to the extent of the margin required by wholesalers.

Some sellers classify their customers not only by levels or planes of operation, i.e., on a functional basis, but also by type or method of operation on a given level or plane. For example, retailers may be classified as chains, department stores, mail order institutions, and independents, and a different price charged for the same product on sales to each of these classes. Inasmuch as functionally all of these customers are on the same level, it would seem that any price differential among them would have to be justified by specific economies effected by the seller by reason of sales to the class of customers receiving the lower price or by the other escapes provided by the law.

Legal Aspects of Functional Discounts. This policy has given rise to considerable controversy, for it made possible some price discrimination by placing certain types of outlets in a more favorable classification than others. Efforts have been made, with varying degrees of success, on the part of department stores, chain stores, and various cooperative exchanges or buying pools of small retailers to class themselves as wholesalers so that they might enjoy the advantages of functional discount scales. Some of these efforts have resulted in court action, the two most prominent cases being the *Federal Trade Commission v. the Mennen Company*[4] and the *National Biscuit Company v. Federal Trade Commission.*[5] In the Mennen case, for

[4] 288 Fed. 774 (CCA-2, 1923), certiorari denied, 262 U.S. 759 (1923). See also *The Great Atlantic and Pacific Tea Company v. The Cream of Wheat Company,* 227 Fed. 46 (CCA-2, 1915), involving a similar decision which denied the A & P a wholesaler's status.

[5] 299 Fed. 733 (CCA-2, 1924), certiorari denied, 266 U.S. 613 (1924).

example, the Federal Circuit Court of Appeals of the Second Circuit reversed the decision of the Federal Trade Commission, declaring that "whether a buyer is a wholesaler or not does not depend upon the quantity he buys. It is not the character of his buying, but the character of his selling which marks him as a wholesaler." Accordingly, the Mennen Company had the right to refuse to sell to retailers altogether and to decline to sell to them at the same scale of prices used for wholesalers, regardless of the fact that such retailers purchased in large quantities individually or collectively. It was held that the fact that retailers saw fit to organize themselves into a cooperative or mutual corporation for purchasing purposes did not change their character nor did it convert them into wholesalers. It does not follow from this, however, that it would be advisable for a seller so to class cooperative *wholesale* establishments, although such classification is not prohibited by law. Few manufacturers will, in view of the growth of such organizations, find this plan feasible. In fact, it is difficult to see any difference between the activities of such cooperatives, particularly when control is retained by the promoters, and of other types of wholesale institutions, so long as they distribute their products at wholesale to retail dealers exclusively.

Again, in the National Biscuit Company case the court put aside an order issued by the Federal Trade Commission, and permitted the company to discriminate between chain stores and buying pools of retailers by quoting higher trade discounts to the former, inasmuch as there are important differences between the two types of retail organizations. Whereas each member of the pool controls his own business and is liable for his own indebtedness, the manager of the chain assumes complete financial responsibility for all deliveries made to the individual stores of the organization. Furthermore, the deliveries to the individual units of the chain permit the seller to exercise more effective control in preventing the sale of undesirable goods and in rendering dealer aid. Finally, the advertising of the chain store inures to the benefit of the seller's products.

Insofar as legislative provisions are concerned, there seems to be nothing in the original Section 2 of the Clayton Act (1914) about functional discounts per se. Except for the cases cited above which sanctioned functional discounts, the subject has been in a state of judicial indecision under that law. Nevertheless, the escapes provided under that section of the Clayton Act with reference to (1) purchases in different quantities by the different classes of customers and (2) not affecting *general* competition were broad enough to permit many functional classifications to exist. It is believed, however, that these two escapes have been substantially narrowed by the language of the Robinson-Patman Act (1936) which amended the old Section 2 of the Clayton Act.

Since the Robinson-Patman Act itself is silent on the matter of functional discounts, it may be inferred that it does not make them mandatory but that it perhaps leaves the subject *in status quo* were it not for the possible effect of certain language in the law and the questions raised about it by the Federal Trade Commission, the enforcement agency. As this law gives no independent status to functional discounts, where interstate commerce is involved, a functional discount, like any other price discrimination, may certainly be justified by one of three factors: (1) a saving in cost to the seller, (2) an attempt in *good faith* to meet competition, and (3) no adverse competitive effect upon other sellers, as between different buyers, or as between customers of the different buyers. Many cases can be cited which involved these questions.[6]

It is interesting to note, however, that in all these cases and wherever the question of functional discounts has been raised so far under the Robinson-Patman Act the wholesalers involved were atypical. In no instance were the wholesalers bona fide in the sense that they were selling only at wholesale, but in each instance they were of the split-function type in which retailing was combined in some degree with wholesaling. In all such instances it has been the Commission's position that functional discounts may be allowed only on that portion of a customer's purchases which he resells at wholesale, unless the lower price can be otherwise justified. While there may be some justification for such a position in certain instances, in most cases it involves almost insurmountable practical problems of business operation; and the matter has been carried too far when the split-function idea is applied to two different stages on the same *plane* of operation as when a seller is required to differentiate between selling to a primary distributor who is also a wholesaler and to a wholesaler who is also a so-called sub-jobber.

In any event, there has as yet been no challenge of the functional discount when applied to wholesalers who do nothing else but operate to the full extent of their sales as wholesalers. In view of the economic analysis of the basis for functional discounts at the beginning of this section, there should be no cause for doubting the reasonableness of such a policy when so applied. Furthermore, there is nothing in the law, in judicial decisions, or in the action of the Federal Trade Commission to date that would oppose this viewpoint, mainly because in none of such cases is there injury to competition.

Special Promotional Discounts. Special discounts often form part of a manufacturer's pricing system. These discounts may be allowed for adver-

[6] A few of these cases are: *Nitragin Co.*, 26 F.T.C. 320 (1938); *Miami Wholesale Drug Corp.*, 28 F.T.C. 485 (1939); *Sherwin-Williams Co.*, 36 F.T.C. 25 (1943); *Standard Oil Co. v. F.T.C.*, U.S. Supreme Court, January 8, 1951; and *Doubleday and Co., Inc.*, F.T.C. order to cease and desist, Docket 5897, dated September 2, 1955.

tising purposes, for special services rendered to the vendor, for the employment of demonstrators in the buyer's store, for so-called "P.M.'s" ("push" money), and for other sales promotional devices. Frequently, these discounts have been given for one or more of the alleged purposes mentioned above without the slightest expectation of their use in the manner indicated. In such cases they merely amounted to a reduction from the prices charged to others and were thus allowed only to favored customers. The Robinson-Patman Act forbids any such special allowances unless they are made available to all of the firm's customers on proportionally equal terms.

Quantity Discounts. What are known as quantity discounts are discounts granted by vendors to customers who purchase in larger quantities than those to which the net price or regular trade discount applies. They may relate to individual shipments or to a series of purchases over a period of time. Thus quantity discounts fall into two general categories, noncumulative and cumulative. These discounts may apply to all kinds of goods handled by a vendor or only to shipments of goods on which increased sale is most desirable. Sometimes quantity discounts take the form of "free deals," regular prices being charged for all goods actually invoiced which do not include the extra packages.

Noncumulative Quantity Discounts. This type of discount is based upon the dollar amount or the physical volume of goods bought at a single time and, usually, delivered at a single place. An example of such a schedule is as follows:

Quantity Included On Single Order	*Discount from Regular Price*
1 dozen	0
1 dozen–1 gross	1%
1 gross–10 gross	2%
10 gross–50 gross	2.5%
50 gross–100 gross	3%
over 100 gross	3.5%

When a variety of goods is sold by a firm, it is rather common to relate a quantity discount schedule to the dollar volume represented by a single shipment rather than the number of units as shown in this example.

The principal purpose of noncumulative quantity discounts is to encourage customers to buy in larger quantities. To the seller this means not only economies in actual selling but savings in such items as office expense, packing, and delivery costs, the economies in all of which may vary rather directly with size.

Cumulative Quantity Discounts. Cumulative quantity discounts are based upon total dollar purchases over some specified period of time, for delivery to a single place or a number of different destinations, depending upon

particular circumstances. Such discounts are usually expressed in a classification schedule similar to the following:

Amount of Purchases per Month	*Discount from Regular Prices*
less than $ 200	0
$ 200 to 500	2%
500 to 750	3%
750 to 1,000	4%
1,000 to 1,500	5%
1,500 to 2,500	5.5%
2,500 to 5,000	6%
over 5,000	6.5%

Such discounts are often based on a period of one year, if seasonal factors are involved, rather than a month. Discounts are handled in one of two ways. A customer may be entitled to a discount on his current purchases because of the volume of his purchases in a preceding discount period, either a year or month, as the case may be. An alternative commonly encountered is that of rebating the amount of the discount earned during the current period after the customer's purchases have been cumulated for that period.

As might be inferred from the above schedule, the principal purpose of cumulative quantity discounts is to encourage customers to concentrate their purchases or to deal exclusively with the house offering the discount. According to the illustration, after a certain volume of purchases, say $500, has been reached, the customer has earned a 3 per cent discount. If his remaining requirements for the month approximate $250, he will likely place orders with the same source in order to earn 4 per cent discount not only on the $250 but also on the $500 worth of merchandise previously purchased. Thus, so long as there is a reasonable probability of attaining a higher discount classification, the effect is to limit the customer's freedom in selecting sources of supply.

Other Purposes of Quantity Discounts. Several other purposes are often associated with both noncumulative and cumulative quantity discounts. When the schedule covers two or more commodities produced by a single seller, there is a tendency to "full-line forcing," this tendency becoming stronger as the margins between two successive minima on the scale decrease.

In addition to effecting economies in selling and handling, both types of quantity discounts frequently result in manufacturing or producing economies. Insofar as quantity discounts prevent buyers from dividing their business among a number of sources of supply, to that extent purchasers tend to concentrate their buying, thereby offering a greater volume of business to a given seller than he would otherwise obtain. This naturally leads to a better utilization of plant capacity and to a general reduction in factory costs.

Quantity discounts are also used for the purpose of stimulating sales of lucrative lines of merchandise. Some concerns confine these discounts to shipments of private brands or other specified articles which produce an especially good margin of profit.

Effects of Quantity Discounts. Every system of quantity discounts offers relatively greater advantages to large buyers because of the lower net prices resulting therefrom. There is a tendency, however, especially for the noncumulative discount, to result in an overloading of buyers whose purchases become inconsistent with their sales volume. Sometimes these discounts induce small buyers to pool their purchases with those of others in order to take advantage of the lower prices and thus be enabled to compete with their rivals.

Another effect of a system of quantity discounts is to force competitors either to adopt a similar system or to sell at net prices that would equalize the advantages of the competitor offering the quantity discounts. The more exclusive the discount scale is, the more it tends to force competitors to offer even more liberal discounts or lower net prices, since that may be the only opportunity to induce purchasers to divide their business among two or more sellers.

Legal Limitations. Neither noncumulative nor cumulative quantity discounts are legal or illegal per se. Legality under the price discrimination provision of the Robinson-Patman Act depends upon several factors which vary from case to case. Generally, such discounts are legal if they are in line with savings effected by the vendor as a result of selling in larger quantities or obtaining a larger volume of business from particular customers. The burden of proof that the discounts do not exceed cost savings is upon the seller who is presumed guilty of price discrimination unless he can establish factually that the discounts meet this requirement, also upon the buyer who knowingly receives the discrimination. For the seller this usually necessitates a careful analysis of distribution costs by various classes of customers according to the soundest bases for allocating such costs to customers or customer groups. Parenthetically, it should be observed that when quantity discounts are granted, they need not be equal to cost savings, but simply must not exceed them. The law does not prohibit discounts which are less than the savings that may be realized by the seller.

In order to comply with legal requirements, division of customers into classes for quantity discount purposes must be reasonable and not arbitrary. Classes must not be unduly large in amount and too few in number. Boundaries between classes must be reasonably placed, if possible at points where it can be shown that the cost of doing business changes most conspicuously. For example, in the foregoing illustration of a noncumulative quantity discount schedule, a division of all customers into only two classes

—those who purchase less than 50 gross and receive no discount and those who purchase more than 50 gross and receive a 4 per cent discount—would not be reasonable. There would be only a small difference between the cost of servicing the 40 gross purchaser and the 60 gross purchaser but a substantial difference in the price paid by each. Finally, the same schedule must be made available equally to all customers of a given class (e.g., wholesalers or retailers); none may be excluded arbitrarily or capriciously.

Even if these classification requirements are met, there is a further limitation in that the Federal Trade Commission is authorized under the Robinson-Patman Act to fix maximum quantity limits beyond which further price differentials are not permitted. This limitation was included in the law for the purpose of dealing with cases where available purchasers in greater quantities are so few in number as to render differentials on account of the larger purchases unjustly discriminatory or promotive of monopoly. As a matter of practice, this limit has seldom been invoked, but activities of the Federal Trade Commission lead to the belief that it may be of more significance in future legal proceedings. In the Morton Salt Co. case, for example, it was alleged by the Commission that the company's price schedule allowed reductions in price for carload lot and larger shipments of table salt, but that there were only five purchasers, all chain store organizations, that were able to qualify for the largest savings in price. The Supreme Court in 1948 upheld the Commission in ruling that this schedule put the larger number of buyers at a competitive disadvantage by their inability to obtain such an extensive price reduction.[7] Similarly, in 1947 the Commission instituted a long-range investigation of the rubber tire industry with a view to placing maximum limits upon the quantities to be used in calculating price differentials. The purpose in this study was to determine the point of volume at which savings based thereon become available to only a small group of dominant purchasers. This determination was made and a ruling[8] was issued, effective April 7, 1952, setting a 20,000 lb. carload as the maximum discount unit on replacement tires and tubes. The validity of this order was challenged by practically all the tire and rubber companies and other affected parties, and the matter is still in the courts.[9]

While in general the same legal considerations apply equally to cumulative as well as noncumulative discounts, the Commission and the courts are much less likely to countenance those of the cumulative type because they cannot be related so directly to any form of cost saving. The example of a cumulative quantity discount schedule given on a preceding page may be used to illustrate this point. Suppose that "Customer A" purchases in one month one order which totals $400 and obtains, according to the sched-

[7] 334 U.S. 37 (1948).

[8] *Quantity-Limit Rule 203-1,* 17 Fed. Reg. 113.

[9] *The B. F. Goodrich Co. v. F.T.C.,* 208 F.2d 829 (D.C. Cir., 1953).

ule, a 2 per cent discount. Compare this with "Customer B" who may purchase a total of $1,000 worth of goods during the month on which he obtains a 5 per cent discount, even though this may have involved ten separate purchases of $100 each, ten salesmen's calls, ten orders filled and handled, ten deliveries, ten invoices mailed, and ten accounting entries. Clearly, in the case of "Customer A," the costs of marketing are substantially lower in relation to the business transacted, but this situation is not and cannot be fully reflected in a cumulative quantity discount schedule. In general, however, customers who buy a large volume during a given period are also more apt to purchase in larger individual orders than those who buy a small volume during the same period of time.

Price Guaranties. Many producers, especially in the case of goods sold by wholesalers and retailers on a seasonal basis, guarantee their prices against declines. This is done to secure orders sufficiently in advance of production to permit a schedule or program for continuous plant operation. A guaranty against price decline usually takes the form of a contract to make a rebate to the buyer who may be a wholesaler or retailer, in the event that the vendor reduces his price prior to a specified date. The effect of such a guaranty is to induce such wholesaler or retailer to place his order in advance of actual need for the merchandise and to enable the manufacturer who makes the guaranty to produce his goods to order rather than for stock. It also tends to tie up a customer's trade, for, when combined with favorable season datings, it may induce a buyer to purchase his entire season's requirements from a single source.

Guaranties against price decline are also commonly used in contracts for the instalment delivery of goods over a considerable period of time. In the steel and coal industries it is common practice to give such a guaranty on all undelivered tonnage. Another use to which manufacturers put guaranties against price decline is that of stimulating sales during periods of dullness resulting largely from uncertainties on the part of purchasers as to price trends, as during periods of depression.

Insofar as guaranties against price decline, used to stimulate sales in periods of dullness, are carefully planned and administered and are based on a reasonable interpretation of market conditions, they serve a very useful purpose. Manufacturers are thus enabled to liquidate their excessive inventories of raw materials much more promptly than would otherwise have been possible. Insofar as such practices result in a restoration of confidence, they are distinctly advantageous. The danger, however, in the use of guaranties at such a time is obvious. When the manufacturer is operating in a highly competitive trade, his own prices must conform to those of the market if he is to continue to operate and to enjoy the confidence of his customers. If competitors reduce their prices, he is practically forced to lower his own,

and the result may be a heavy financial loss. Furthermore, it is clear that if such guaranties induce reckless overestimation of their needs by customers, the result later on will be a surplus of goods in the hands of buyers and a stagnation in trade greater than would have existed in the absence of guaranties. It should be noted, however, that the tendency toward speculation by buyers has as a counterinfluence the losses which they may suffer through a decline in prices after shipment. Self-interest dictates that, if the guaranty applies only to date of shipment, the buyer should avoid the accumulation of excessive inventories.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   a) odd price
   b) single price policy
   c) price line
   d) one-price policy
   e) varying price policy
   f) trade discount
   g) functional discount
   h) net price
   i) quantity discount
   j) cumulative quantity discount
   k) noncumulative quantity discount
   l) price guaranties
2. How is the Robinson-Patman Act related to questions of policy formation which involve:
   a) varying price policies
   b) functional discounts
   c) special promotional discounts
   d) trade discounts
   e) noncumulative quantity discounts
   f) cumulative quantity discounts
3. Assuming reasonable efficiency among a number of retailing competitors, is it possible for one consistently to undersell all others on all items? Explain.
4. The manager of a small appliance store sells a washing machine to one customer at the manufacturer's established price of $199.50. A few minutes later, in dealing with another customer interested in the same machine, he shades the price by $15 in order to make sure of getting the sale. Is this a violation of the Robinson-Patman Act? Explain.
5. If price discrimination is prohibited by the Robinson-Patman Act, how can you explain the fact that varying price policies are nevertheless rather commonly encountered in wholesale trade?
6. What is "odd" about an odd price policy? Explain its use and reasons for it.
7. Locke and Son Company wholesales a general line of dry goods in the North Central States. In the past, salesmen have been given the privilege of "shading" the price on certain items in order to meet competition. The new sales manager says he thinks that this practice must be stopped because he feels that it is illegal. Upon what basis may he have reached this conclusion? Is he right? What price policy was being followed and to what policy was the change to be made?
8. Assume that you are a hardware wholesaler and that your customers fall roughly into three types of buyers, to which you give different prices on

their wholesale merchandise. Smith represents the first type which you call *average*. He buys an average amount; takes his 2 per cent cash discount in 10 days on about half of his purchases and pays regularly for the rest in 30 days. Jones represents the next type. He buys infrequently, but in very large amounts and takes the 2 per cent discount every time. You give him a little better price. Hawkins is the third type and is your least desirable customer. He buys very small amounts, pays slowly and irregularly, and always wants to higgle about the price. You charge him more than either of the others. How can you justify the last two customers' treatment in the light of fairness to all? Is it legal? Explain.

9. Assume that you are the owner of a canning factory which packs peas. Ordinarily you put up the entire pack under your own label and sell (mostly) to wholesale grocers within the state. You charge them $1.50 per dozen for Standard #2 cans. This year, just before your packing season, you were called upon by an A. & P. buyer who offered to take your entire pack for $1.25 per dozen, to which you agreed. Can you afford to take 1/6 less for your entire year's output by contracting at a fixed price so far in advance? Will it pay you to spend the remainder of the year, which has formerly been devoted to marketing, in idleness? Can you afford to lose contact with all your former wholesale customers, and subsequently be at the mercy of a chain grocery bidder in selling your pack?

10. A leading shirt manufacturer has been advertising and selling for years a quality line of shirts at $3.75 through exclusive men's stores and department stores. With rising material and labor costs, the company was faced with two alternatives: (a) to reduce the quality of the line and maintain the $3.75 price, or (b) to advance the price to cover the rising costs and maintain the established quality. If the latter course were adopted, it would be necessary to retail the shirts at $4.50 or $4.75. Which of these courses of action would you recommend for the manufacturer? Explain your decision carefully.

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PRICE FIXING AND PRICE CONTROL

That some rigidity and uniformity characterize segments of our pricing structure has already been implied or directly shown in the two preceding chapters. Among the factors that bring this about are monopolistic or quasi-monopolistic control of supply, mechanization of industry and the large-scale production that follows, branding that is bolstered by huge sums for advertising, and rapidly changing styles. Open price agreements, certain trade association activities, and many other practices have contributed to the same end. In this chapter an attempt is made to discuss certain business and public policies which make for price rigidity and uniformity.

Delivered Pricing Systems

As used in this discussion, the term "delivered pricing system" refers to any arrangement whereby different sellers in the same industry charge the same delivered price for their products at any given destination. Basing point systems are the best known examples. Such systems have generally developed in industries characterized by a highly standardized product and where transportation costs are substantial in relation to the value of the commodity. While "systematic" industry pricing arrangements are considered illegal in view of certain court decisions, *identical* delivered prices (as distinguished from *uniform* prices that may be charged by any one seller all over the United States) may still result from noncollusive action of producers.

A knowledge of the operation of such systems is indispensable to the marketing student because they have had a profound effect upon industrial and marketing development in this country, because of their influence upon

plant location, selection of sources of supply, ability to compete, and extent of market areas, and because of numerous controversial economic and legal questions to which they have given rise.

Background and Early Development.[1] Basing point and other delivered pricing systems had their origin in a transition in our economy from a highly competitive situation to one that contained, at least in certain segments, many monopolistic elements. Technological developments following the Civil War brought in their wake very great advantages associated with large-scale operations. In order to acquire the increased volume of business necessary to use new mass production methods, many of our industrial firms resorted to severe attacks upon their rivals in the form of temporary and punitive price cutting. The ensuing elimination of numerous smaller firms in many heavy industries left a small number of large companies who, being fearful of the results of such further actions, resorted to "pools," trustee devices, and outright mergers in order to gain a substantial degree of market control within their industry.

Prior to World War I, several antitrust actions were prosecuted by the Department of Justice and were sustained in Supreme Court decisions. These early antitrust actions did not, however have the effect of restoring price competition because in many industries the number of sellers had become too small for any one of them to ignore the effect of changes in output upon the price of the commodity and, hence, upon his own revenue.

In such an oligopolistic situation, there is a great obstacle to price cutting because the estimated demand for the product of any one firm depends largely upon the price policies which are followed by competing sellers. If the product is not highly differentiated (i.e., if consumers do not prefer the product of one seller to that of another) and if each seller realizes that a reduction in his price will be immediately matched by his rivals, then he feels that he may obtain a share of any increase in total demand but that it is impossible for him to attract any business away from his rivals by means of a price reduction. In the case of many industrial goods, particularly semimanufactured commodities, the group of sellers constituting an industry believe that the demand for their aggregate output is inelastic, i.e., it will not increase more than proportionately with a reduction in price. Therefore all such sellers resist demands for lower prices because it is believed that little would be added to their total unit sales, and a lowering of price would result merely in a reduction of total revenue. Such a situation eliminates in-

[1] Undoubtedly the most comprehensive and most authoritatively documented treatment of the origin and background of basing point and other delivered pricing systems is to be found in Arthur R. Burns, *The Decline of Competition* (New York: McGraw-Hill Book Co., Inc., 1936). For a concise but detailed statement of the legislative and judicial history of delivered pricing, see *Report of the Attorney General's Committee to Study the Antitrust Laws* (Washington, D.C.: Government Printing Office, 1955), pp. 209–21.

centives for price cutting and induces smaller firms to follow the price policies of industry leaders. Then the price of the product may become the same as if there were but a single firm in place of the group.

If products are heavy in relation to their value, transportation costs become an important component of the value at points distant from places of production. Purchasers therefore consider not the price realized by producing mills but the landed cost of the commodity at the point at which they accept delivery. Mills located near important customers therefore have a substantial price advantage in selling to these customers, even though industry factory prices might be standardized. In order for more distant mills to compete, it is necessary for them to match the delivered price charged by the more favorably situated producers. Conversely, a favorably situated mill does not have to reduce prices below the level of delivered prices that would be quoted by more distant producers. As shown in the more detailed discussion in the following specific examples, it is the condition of a standardized industry product coupled with substantial transportation costs that has given rise to various types of delivered pricing systems.

Types of Delivered Pricing Systems. In essence, delivered pricing systems involve some procedure by which variously located competing sellers adjust their realized mill net return in order to arrive at identical delivered prices at any given destination. This has been accomplished by means of single basing point systems, multiple basing point systems, or zone delivered pricing systems.

In a single basing point system, the delivered price at any destination is the sum of the price at the basing point plus freight charges from the basing point to delivery point, regardless of the actual shipping point or actual freight charges paid by the seller. Prices are determined in a similar manner under a multiple basing point system, except that a number of different bases are recognized by the industry. Such bases have generally been fewer in number than the mills constituting an industry and in some cases have even been established at points where there is no producing mill. In a zone delivered pricing system the country is divided into a number of zones, and the seller or sellers quote the same delivered prices to all customers within a given zone. Each of these methods is illustrated with reference to a particular industry in the following paragraphs.

Single and Multiple Basing Point Systems in the Steel Industry. The development of a single basing point system in the steel industry and its gradual evolution into a complicated multiple basing point system is typical of several other industries which were confronted with similar conditions. After about 1875, steel companies in the Pittsburgh area began to dominate the market and an oligopolistic situation prevailed. From that time until the 1920's prices throughout the industry were quoted on a delivered basis,

the delivered price consisting of the Pittsburgh price plus all rail freight to destination, which became popularly known as the *Pittsburgh-plus* system. During this period about 90 per cent of the industry's sales of plates, shapes, bars, wire products, and sheets were made on the Pittsburgh-plus basis. The system was under constant pressure, particularly from steel users located near mills in other parts of the country who had no alternative but to pay substantial amounts of *phantom* freight whenever orders were placed with local mills. The Federal Trade Commission was pressed into action by the vociferous nature of such protests, and in 1924 it ordered the abandonment of the system.[2] This order resulted in the relinquishment of the Pittsburgh base for many steel products and gave rise to a multiple basing point system with bases established at Birmingham, Chicago, Duluth, Cleveland and a number of other points. Additional bases were added from time to time as new companies and new steel manufacturing centers became of greater importance.

Because there are thousands of steel products which vary in size, shape and technical characteristics, opportunities for price competition have been very great. Producers controlling about 95 per cent of industry production belong to a trade association, the American Iron and Steel Institute;[3] and through this association competition was controlled by a standard classification of products with some designated as "base" products for regular pricing purposes. In addition there were "extras" or "amounts added to or deducted from the base prices announced for product classes in order to take care of the particular buyer's specifications of size, special quality, special treatment, or quantity."[4] According to allegations of the Federal Trade Commission, industry leaders collectively maintained uniform established prices, not only for "base" products, but also for the additional amounts to be added as "extras."

Pricing practice involved the designation of a number of locations as bases for which prices were announced. Base prices became one component in a formula used for arriving at identical delivered prices. The other component has been known as the "freight rate applicator." Independent action on the part of producers could not result in exactly identical delivered prices in all instances because the calculations involved in the determination of shipping charges (including rates, routes, and switching) are so complex that even expert traffic officials are frequently in disagreement. Therefore, a commonly agreed-upon "freight applicator" was provided in a list of charges

[2] *Federal Trade Commission v. United States Steel Corp.*, F.T.C. Docket No. 760. A petition to dismiss the cease and desist order was denied in 1945 by CCA-3, and a consent decree affirming the order was obtained in 1948.

[3] *Complaint in the Matter of the American Iron & Steel Institute et al.*, F.T.C. Docket No. 5508 (1947).

[4] *United States Steel Corporation, T.N.E.C. Papers* (United States Steel Corporation, 1940), Vol. III, p. 13.

to be added to base prices in lieu of actual shipping, switching, and freight charges. These "freight applicators" could be found in the freight-rate books published and distributed by the Iron and Steel Institute. Producers then employed base prices plus published applicators to arrive at the quoted price at any destination. Vendors therefore could disregard actual shipping points, actual means of transportation, and actual shipping charges incurred. A producer might thus collect phantom freight in his quoted delivered price or he might have to absorb some actual freight charges out of revenue, depending upon whether or not he was closer to the customer than the basing point. A multiple basing point system almost identical to that used in the steel industry was for many years followed by cement producers, and in this case the system was also implemented by a trade association known as The Cement Institute.

A Zone Delivered Pricing System in the Sale of Packaged Corn Derivatives. A policy closely allied in some respects to basing point systems is the zone delivered pricing system. Under it, the product is sold on a basis which results in uniformity of delivered prices within each of several specified geographic zones, so that all buyers in a given zone pay exactly the same price for the goods. This may be illustrated by the practices of some important companies engaged in the sale of packaged corn derivatives such as corn and gloss starch, syrup, corn sugar, and refined corn oil.[5] Through the trade association and other meetings, leading firms discussed and exchanged information on current prices, terms of sale, future price quotations, etc. Through joint action, they divided the country into a number of territories within which the same delivered price was quoted to all customers of the same class. This may be illustrated by the delivered price quotations followed by the industry in the sale of small packages of refined corn oil in the early 1940's. All sales were made, it is alleged by the Federal Trade Commission, on a delivered basis, in accordance with the following schedule:

Territory	*Price per Case*
1	$13.75
2	13.75
3	14.05
4	13.95
5	14.05
6	14.15
7	14.20
8	14.25

When such a system is followed by all producers in an industry, regardless of plant location, differences in delivered prices do not reflect actual or reasonable approximations of differences in transportation costs. A manu-

[5] This discussion is based upon allegations of the Federal Trade Commission as contained in its *Complaint in the Matter of the Corn Products Refining Co. et al.,* F.T.C. Docket No. 5502 (1947).

facturer located in zone 6, for example, would realize a high mill net return upon sales made in his own territory but would have to absorb considerable freight in selling in zones 1 and 2 which were the territories dominated by the major production facilities of the leading manufacturers.

Products That Have Been Sold Under Delivered Pricing Systems. Until certain modifications were effected following the Cement Institute case decision in 1948, which is noted below, the use of one or another of the foregoing delivered pricing systems was very widespread, particularly in the case of many important industrial goods, including the following:

Asphalt shingles and roofing	Lumber and lumber products
Bolts, nuts, and rivets	Metal lath
Bricks	Paper
Building tile	Pig iron
Cast iron soil pipe	Power cable
Cement	Range boilers
Corn derivatives	Salt
Fertilizer	Sewer pipe
Floor tile	Steel
Gypsum plaster	Sugar
Industrial alcohol	Valves and fittings
Lime	White lead
Linseed oil	Window glass

Other Forms of Freight Equalization or Absorption. Even some wholesalers and manufacturers who sell principally on an f.o.b. basis "split," or absorb, some portion of freight charges to certain competing centers. They use what is known as the "geographical equalizing" method, whereby freight is paid by the seller part way to competing cities in order to make it equally advantageous for buyers located in these communities to purchase from one center as from another.

Also, many manufacturers, in order to make possible uniform retail prices throughout the country, sell at a uniform delivered wholesale price to all destinations. Such a practice, of course, involves absorbing freight charges on distant shipments and the collection of phantom freight in the case of sales to nearby customers. All purchasers, however, are placed on the same basis, regardless of location.

Economic Arguments Relating to Delivered Pricing Systems. Considerable controversy has raged over the economic implications of basing point and other delivered pricing systems and has given rise to much comment, discussion, and argument by economists. Opponents of this policy of pricing goods claim that it results in collusive bidding, price uniformity and rigidity, and practical monopoly control. Mill or f.o.b. prices are said to be the only way to maintain free competition, for basing point systems lead to

price understandings. Since every producer knows what price he will have to charge at every point of delivery, the absorption of freight charges when selling at a distance is not so much a means of geographical price equalization as it is part of a noncompetitive price plan. There is no incentive on the part of any producer to reduce his prices in order to secure more business. Moreover, it is unjust to customers located near mills that are not used as basing points. They still pay the freight from the nearest basing point, which may be at a considerable distance, even though the commodity is delivered from a local mill. This leads fabricators and other consumers of the commodity to locate near basing points, even when other factors would make another location more advantageous. Finally, the interpenetration of markets which results from a basing point system increases the aggregate transportation costs and thus contributes to waste in distribution.

On the other hand, supporters advance several arguments in favor of delivered pricing systems. A substitution of prices quoted f.o.b. mill will, it is claimed, create virtual monopolies in favor of those mills which are located near advantageous markets. Production would eventually be seriously curtailed in some of the largest producing areas, for it would close the door of national markets and confine competition within restricted areas. A purchaser would be virtually at the mercy of the nearest mill. Above all, it would be contrary to the workings of the law of supply and demand which presumably now fixes the prices of such products as steel in any one territory. Regardless of its other effects, delivered pricing permits the interpenetration of geographic markets, thus encouraging wide opportunity for competitive price shading, which may keep terms of sale more flexible and more responsive to market shifts than they would be under mandatory f.o.b. mill pricing.

Some purchasers of commodities that have been sold by delivered pricing systems also argue in favor of such systems. They claim that under a basing point system they know in advance what different supplies or materials will cost, regardless of the specific source, and that they can make production and marketing plans accordingly. Under f.o.b. mill net pricing by their suppliers, there are important differences in costs between differently situated suppliers. Thus an industrial consumer who finds that his usual or nearby source cannot make delivery may be forced to purchase from a distant mill and pay much higher than anticipated transportation costs which may disrupt his whole program. It is probable that this argument has been advanced most frequently by industrial consumers who have been located most favorably with respect to basing points and not so frequently by those who have had to pay considerable amounts of phantom freight under such a pricing system.

Important Court Decisions Affecting Delivered Pricing Systems. In all the types of delivered pricing systems discussed in preceding paragraphs,

two infractions of the law may be present. Conspiracy in restraint of trade, due to the collective action of several members of an industry, violates the Sherman Antitrust Act and may be interpreted as an unfair method of competition under the Federal Trade Commission Act. Second, price discrimination resulting from the fact that the prices paid by customers are actually different mill net prices that cannot be justified by cost considerations is a violation of the Robinson-Patman Act. These violations have been ruled upon in several crucial cases involving delivered pricing systems.

The Corn Products Cases. In 1945, the Supreme Court handed down two decisions that have an exceedingly important bearing on the basing point pricing system and indirectly also on zone delivered uniform pricing. They dealt with the pricing policies of the Corn Products Refining Company and the A. E. Staley Manufacturing Company.[6]

The principal basing point practice complained of is illustrated by the following. The Corn Products Refining Company had two plants for the manufacture of glucose or corn syrup, one at Argo, Illinois, within the switching district of Chicago, and the other at Kansas City, Missouri. Bulk sales of the product to candy manufacturers, for example, were made at delivered prices, which were computed at Chicago prices plus the freight rate from Chicago to the place of delivery, even though the product was actually shipped from Kansas City. In this way purchasers in all places other than Chicago paid a higher price than did Chicago purchasers, so that the delivered prices frequently included unearned or "phantom" freight to the extent of the difference in the freight actually paid and that charged to the purchaser. If, on the other hand, the freight actually paid was higher than that charged on the f.o.b. Chicago basis as in the case of shipments made from the Kansas City plant, the freight was *absorbed* by the company to the extent of such difference. The Commission charged that both these practices resulted in price discrimination such as prohibited by the Robinson-Patman Act, and its position was finally upheld by the Supreme Court.

The Cement Institute Case. Violations concerning both conspiracy in restraint of trade and price discrimination were ruled upon in the Cement Institute case when it reached the Supreme Court in April, 1948, after eleven years of investigation, hearings, and prosecution in lower courts by the Federal Trade Commission.[7] Conspiracy was indicated by the *identical* delivered prices quoted to the government by cement producers who had long used a multiple basing point system very similar to that employed in the steel industry. An example of bids by eleven companies which were

[6] *Corn Products Refining Co., et al., v. Federal Trade Commission,* No. 680, and *Federal Trade Commission v. A. E. Staley Manufacturing Co.,* No. 559. October Term, 1944, April 23, 1945, 324 U.S. 746, 65 S. Ct. 971.

[7] *Federal Trade Commission v. Cement Institute et al.,* U.S. Supreme Court, Nos. 23–24, October Term, 1947, 333 U.S. 683, 68 S. Ct. 793.

identical in terms of $3.286854 per barrel was accepted as one form of reasonable proof that some sort of an illegal price understanding pervaded the industry. In addition, freight rate applicator books of the Cement Institute were produced at the trial and were found to be at considerable variance with actual rates in many instances. These books were accepted as additional evidence that producers were conspiring by using trade association information for pricing purposes without engaging in competition.

Price discrimination was found, as in the corn products cases, in the fact that phantom freight and freight absorption devices were utilized. The court upheld the Commission in its ruling that the practice of varying mill net returns by absorbing freight from some customers and collecting phantom freight from others is a violation of the price discrimination provision of the Robinson-Patman Act, because it could not be defended on the basis of cost savings nor on the basis that all such prices were varied in good faith to meet equally low prices of competitors.

The Steel Case Settlement. At the time of the Cement Institute decision, the Federal Trade Commission was also prosecuting a similar case against the American Iron and Steel Institute and most of its members. Because of the similarity of the issue to that involved in the Cement case, both parties agreed to settle the case by negotiation and a consent decree. This is of particular interest because it involves the most recent pronouncement of the Commission in a major delivered pricing system case, because it points most clearly to the current legal status of such pricing, and because it was uncontested by the steel industry. The order, issued in June, 1951, forbids any agreement or planned common course of action to quote or sell steel products at prices calculated or determined "in accordance with any system or formula which produces identical price quotations or prices or delivered costs, or which establishes a fixed relationship among price quotations or prices or delivered costs, or which prevents purchasers from securing any advantage in dealing with one or more of the respondents as against any of the other respondents."[8] Another provision forbids any common course of action designed to prevent quotation, sale, or delivery of any steel products f.o.b. at point of manufacture. In interpreting the various provisions, the Commission made it clear that uniformity of prices charged by two or more producers at any destination or destinations would not in itself be considered as evidence of violation of law and that it "is not acting to prohibit or interfere with delivered pricing or freight absorption as such when innocently and independently pursued, regularly or otherwise, with the purpose of promoting competition."

Current Situation. These decisions by no means outlaw *all* delivered pricing systems. Those that involve conspiracy or restraint of trade are clearly

[8] Federal Trade Commission Cease and Desist Order No. 5508, August 10, 1951.

illegal under the antitrust laws. Where collusion or conspiracy is not present, legality depends upon the presence or absence of unjustifiable discrimination between competing purchasers. In the Staley, Cement Institute, and the Steel cases, as noted above, the Federal Trade Commission and the courts seemed to look to the "mill net return" as the price to be used to determine whether discrimination actually existed. In more recent cases handled by the Federal Trade Commission, but not adjudicated in the federal court system, attention was directed not to the price realized by the seller at his place of business but rather to the price paid by the buyer. In both the National Lead and Chain Institute cases the original complaint alleged that illegal discrimination stemmed from a multiple basing point approach to pricing which resulted in "differing net prices" at the sellers' plants.[9] The charges were dismissed because of failure to establish a legally cognizable discrimination which, it was asserted, could come into play only by way of "differences in *actual prices* at which the respondent's products *are sold.*"[10] According to authoritative interpretations of the Commission's view in these more recent cases, "the price relevant to ascertaining a discrimination under the Robinson-Patman Act is the *actual* and hence *delivered* invoice price paid by the buyer, regardless of any variations in the seller's mill net returns."[11] Under this view, only significant differences in the invoice prices actually paid by competing buyers could injure any individual buyer's competitive position to the extent necessary to invalidate a "delivered price" as "discriminatory" under the Robinson-Patman Act.

In spite of some apparent conflict in various court decisions and Federal Trade Commission rulings, it appears that delivered pricing practices are legal under a variety of circumstances. If a seller acts independently and not in collusion with other sellers of the same product, a delivered pricing plan or freight absorption is apparently perfectly legal under the following conditions:

1. If the seller is willing to sell on an f.o.b. basis when a purchaser so requests
2. If the seller maintains a uniform delivered price at all points of delivery (rather than on a zone or basing point basis that results in unequal advantages to different buyers), as when he charges nationwide uniform delivered prices
3. If the seller absorbs freight costs, or some portion of them, in order to meet competition, as when his factory price plus actual freight to destination is higher than the amount a customer would have to pay when procuring the same goods from a competitor
4. If the buyers and/or their customers are noncompetitive

[9] F.T.C. Docket 5253 (1953) and F.T.C. Docket 4878 (1953).

[10] F.T.C. Docket 5253, pp. 6–7. (Emphasis supplied.)

[11] *Report of the Attorney General's Committee to Study the Antitrust Laws, op. cit.*, p. 217.

Resale Price Maintenance

A resale price maintenance policy involves the determination by the manufacturer of a price at which an article identified by a trademark, brand, patent, or copyright shall be sold and distributed by purchasers and subpurchasers. Margins of the various distributors are controlled, with particular emphasis on the price paid by the consumer. As the policy refers solely to identified goods, it does not affect the great bulk of nondescript merchandise, including most agricultural products and many manufactured commodities.

Purpose of a Resale Price Maintenance Policy. The main purpose of such a policy is to prevent retail price cutting on standard brands of nationally distributed merchandise. Such articles lend themselves to the purposes of the price-cutting store because they are widely known and in public demand. Whether price cutting is an evil is a subject of considerable controversy. Many sellers commonly fear the practice, and others look askance at pure price competition, yet there are many who regard it as a perfectly natural and wholesome part of our competitive régime, especially when it is used on a profit-yielding basis.

Attempts have been made at various times to offset the effects of price cutting. One of them—the most obvious—has been to imitate the price cutter. This naturally leads to further price cutting, resulting in price wars; hence it is resorted to only sporadically and for short periods of time. Other methods are consequently brought into play which call for a lowering of the quality of the product to permit sales at a reduced figure, or for improvements in the quality or in selling methods which will enable the firm to continue to sell at a higher price than that of competitors. This desire for price peace instead of price cutting has also been responsible for numerous combinations of manufacturers and for the formation of associations which endeavored directly or indirectly to influence prices charged by members.

None of these attempts, however, have proved fully successful. Individual manufacturers have therefore attempted to standardize resale prices, and thus not only offer the public a uniform product whose standard qualities are well advertised, but offer such a product at a uniform price. They hoped that so much good will be created through standardization and intensive advertising that the necessity for price reductions would be lessened. At this point difficulties developed. Retailers saw a possibility of capitalizing on the manufacturer's good will by offering well-known products at a cut price; and the manufacturer discovered at the same time that he could not, with very few exceptions, until the middle 1930's enforce any standardized price upon the retail dealers. This led to a perennial business controversy, which at times assumed considerable prominence.

Causes for Price Cutting by Retailers. To understand the price maintenance controversy, it is necessary to examine the conditions which have given rise to the problem. Among retailers the principal price cutters are chain stores, price appeal department stores, mail order houses, and a relatively small percentage of large or would-be progressive independent stores. Prices are cut mainly on standardized convenience goods and on staple articles sold in stores handling shopping goods primarily. The practice is also not unknown in the sale of numerous specialty goods on which prices are supposedly maintained by means of carefully selected stores which promise to carry out the vendor's merchandising plans and policies. Well-known musical instruments—including pianos, radios and television—so distributed, can be purchased frequently at a discount. Most notable in this area has been the enormous price cutting by certain New York City dealers on the sale of long-playing records. In the sale of automobiles—another specialty good—price cutting is much more common. It is here made possible by increased allowances offered for used cars taken in exchange. It is obvious, therefore, that the whole controversy relates exclusively to the sale of branded merchandise, regardless of the class of goods involved, although the situation is more controllable in the case of specialty goods.

The reasons for price cutting on the part of the retailers who resort to it are several. They purchase in larger quantities than their small competitors, hence they secure advantageous terms in the form of trade and quantity discounts, "free deals," and the like. As they are usually strong financially they are in a position to take advantage of all cash discounts, which are commonly about 1 or 2 per cent but sometimes amount to as much as 5 or 6 per cent of the purchase price. This means that the goods are placed on their shelves at a lower price than that which their competitors have to pay, therefore making it possible for them to undersell their rivals and still earn a reasonably good profit.

Even if a manufacturer or wholesaler charged all retailers the same price for goods, it would still be possible for some of them to undersell others. Some stores offer more limited services, are more efficiently managed, carry more limited assortments of merchandise, can advertise more economically, and in general require a smaller margin over merchandise costs than others in order to realize a profit. Such advantages enable fortunately situated stores to cut prices in order to increase their volume of business, on the assumption that although the profit *per unit* will be smaller, the *total* net profit will be materially greater than if no underselling policy were adopted. This is a sound merchandising principle which every manufacturer will concede.

In addition, price cutters aim to create the impression that bargains are obtainable on all goods in stock. The gullibility of the public makes it possible to use a nationally advertised product as a bait for business on private

branded merchandise, or on goods which are relatively unknown but on which regular or higher prices may be charged sufficient to more than offset any losses incurred through the sale of the "leader." This is a practice which may seriously be questioned on ethical grounds and justifies whatever measures may be deemed practical that would lead toward its elimination.

Price Cutting by Wholesalers. Some wholesalers have engaged in promiscuous price cutting, and for largely the same reasons that explain price cutting among retailers. There are also other causes, including poor salesmanship, inertia, and competition. When salesmen are allowed to vary prices to different customers, the least competent are most likely to resort to the practice. Also, many jobbers who handle primarily manufacturers' brands assert that price competition has been forced upon them by manufacturers. When a manufacturer establishes, through national advertising, a reputation for his product, a wholesaler stocking it has no special advantage to offer to his trade in the sale of this well-known product aside from price, unless the product is distributed altogether on an exclusive agency basis—a practice not frequently encountered in the sale of goods through wholesalers. Thus they are forced to compete principally on a price basis.

Legal Status of Resale Price Maintenance. According to decisions handed down by the courts and the Federal Trade Commission over a period of years a resale price maintenance policy could not be legally enforced until special so-called fair trade legislation was enacted. Any agreement to maintain resale prices was held to be a conspiracy in restraint of trade in violation of Section 1 of the Sherman Antitrust Act and an unfair method of competition in violation of Section 5 of the Federal Trade Commission Act. Merchants also enjoyed the common law right to dispose of their own property, including branded or trade-marked products purchased by them for resale, in any manner and at any price desired. All this was changed with the passage of fair trade laws, which are in essence nothing but statutes legalizing vertical resale price maintenance agreements.

California was the first state to enact such legislation. In 1931 its legislature approved a law designed "to protect trade-mark owners, distributors, and the public against injurious and uneconomic practices in the distribution of articles of standard quality under a distinguishable trade-mark, brand or name." When this law was amended in 1933 to include the so-called nonsigners' clause, which, upon proper notice, makes the resale price maintenance agreement binding upon all parties, whether they did or did not sign it, it gave impetus to the movement and a number of other states enacted fair trade laws in 1935 and 1936. The epochal decision of the United States Supreme Court on December 7, 1936, declaring the California and Illinois statutes constitutional, provided a further impetus to this

type of legislation. When Congress removed the final barrier by the passage in 1937 of the Miller-Tydings Act, discussed below in some detail, state resale price maintenance laws multiplied until they had been specifically adopted in 45 states.[12]

Although 45 states enacted such laws, early in 1957 the number in which the original laws were fully effective had been reduced to 31. In one state (Virginia) the law was inoperative; in five (Arizona, Indiana, Nebraska, South Carolina, and Utah), the laws have been declared unconstitutional within the state court system. In eight states (Arkansas, Colorado, Florida, Georgia, Kentucky, Louisiana, Michigan, and Oregon) state courts have held the laws to be unconstitutional with respect to "nonsigners," which term is explained below, and this has made the laws within these states ineffective for almost all manufacturers who use a large number of outlets for distribution. Within the remaining 31 states where the laws were fully operative, the constitutionality has been positively affirmed by 17 state courts, and it has not been contested in 14 states.

Major Provisions of State Fair Trade Laws.[13] The principal provision of the state fair trade laws is that no contract concerning the resale of any identified or trade-marked commodity which is in free and open competition with other commodities of the same general class shall be held illegal by reason of containing clauses that (a) the buyer will not resell at *less than* the stipulated minimum or *at other than* the absolute price prescribed by the first vendor, and (b) such buyer agrees that he in turn will require any person to whom he may resell to agree not to resell at less than the stipulated minimum or at other than the absolute prescribed price, as the case may be.

In 25 states the laws provided that a resale price may be established by the brand owner or distributor of the commodity; neither is there any limitation on this score in the federal law. In 20 states, however, the right to establish a resale price was limited to the owner of the brand or to a distributor authorized by him. In these states, the danger of someone establishing a price contrary to the wishes of the brand owner or of distributors establishing several different prices (in which case the highest contract price would be the minimum legal price) is thus eliminated.

In all states downward deviations or revisions from stipulated resale prices are permitted: (a) when the inventory is closed out and sale of the commodity is discontinued, but the goods must first be offered back to the vendor at prevailing invoice prices; (b) when the commodity is damaged

[12] Missouri, Texas, and Vermont never had Fair Trade Laws. In Missouri, Texas, and the District of Columbia, resale price maintenance is expressly prohibited.

[13] Detailed information pertaining to the provisions of the various state laws may be found in the loose-leaf reporting service, *Trade Regulation Reporter,* Vol. II, published by the Commerce Clearing House, Inc., New York.

or deteriorated and public notice is given of such condition; (c) when the brand is obliterated; and (d) when sale is made under an order of court.

A price is deemed established for purposes of the fair trade laws as soon as any dealer or distributor signs a contract to that effect with the manufacturer or other brand owner. It then becomes binding upon all dealers and distributors as soon as proper notice is given to them of the price thus established. The application of the so-called nonsigners' clause contained in all of the fair trade laws under the federal statute is discussed in some detail in the following paragraphs.

The second principal provision of the fair trade laws is that whoever *knowingly* and *wilfully* advertises, offers for sale, or sells at less than the minimum or at any other than the absolute price stipulated in *any* contract, *whether or not the violator is a party to the contract,* is guilty of unfair competition. Two remedies are generally provided, which are not mutually exclusive. One is to obtain immediate relief by an injunction that would stop the violation. The other involves action by suit for damages caused by the violation. Action may be brought by the manufacturer or other brand owner, or by the retailer or wholesaler who is injured by the price cutting, provided it can be shown that the violator did it knowingly and wilfully. Adequate machinery must therefore be set up so that resellers may be promptly informed of the prescribed prices and changes therein.

The Miller-Tydings Act. Yielding to pressure from independent retailers, wholesalers, and certain manufacturers for protection against price cutters, Congress enacted a so-called federal fair trade law. This law is commonly referred to as the Miller-Tydings Act, which became effective on August 17, 1937. It directly amended Section 1 of the Sherman Antitrust Act by making lawful vertical price agreements which prescribe minimum prices for the resale of a commodity which carries the trademark, brand, or name of the producer or distributor who owns the trade name, when declared legal by a state either under a statute, by common law, or by public policy of the state. This means that resale price agreements in the 45 states which had fair trade laws were not considered illegal even when interstate commerce was involved, so long as these agreements were vertical in nature. In no case were horizontal price-fixing agreements (between manufacturers, between wholesalers, or between retailers) to be considered legalized by this Act. It also amended, by reference, Section 5 of the Federal Trade Commission Act by providing that the making of such a contract should not constitute an unfair method of competition.

The Wentling Decision. The first important defection in the Miller-Tydings Act was emphasized in a decision by the United States Court of Appeals for the Third Circuit handed down on December 8, 1950.[14] The

[14] *Sunbeam Corporation v. S. A. Wentling,* 185 F.(2d) 903.

effect of this decision was that the Miller-Tydings Act legalized vertical price agreements in interstate commerce with respect to trade in states having fair trade acts only when such agreements did not place an undue burden upon or proved a barrier to interstate commerce. More specifically it was ruled that a fair trade act of a state cannot be used to force retailers within that state to abide by the fair trade price on sales made by them outside that state. Under a proper interpretation of this decision a mail order house which sells in many states could not be bound by the fair trade law of the state of its residence on sales made outside such state, thereby giving such institutions and such method of operation on the retail level an undue competitive advantage. There were other implications in this decision with unpleasant forebodings for the effectiveness of fair trade pricing.

The Schwegmann Decision. By far the most significant defection in the Miller-Tydings Act was evidenced by the decision of the United States Supreme Court on May 21, 1951.[15] In this case, Schwegmann Bros., a New Orleans retailer, refused to sign a resale price maintenance contract with Calvert Distillers, a Maryland corporation, under the state of Louisiana fair trade law and sold the company's products at cut-rate prices. An attempt was made to enjoin the retailer from selling at less than the stipulated retail prices. The company maintained that its price-fixing agreements were legal in interstate commerce under the provisions of the Miller-Tydings Act and that nonsigners were bound by the stipulated minimum price because this was in line with the so-called nonsigner clause of the Louisiana "Fair Trade Law." Schwegmann Bros., however, contended that since it had not signed such an agreement, it could not be bound by it and hence no law had been violated.

Contrary to most public and businessmen's expectations, the U. S. Supreme Court, in a history-making 4 to 3 decision, supported Schwegmann Bros. This decision made it emphatically clear that the federal law did not expressly provide that noncontracting parties are bound to observe the prescribed minimum or absolute resale prices in interstate sales. It immediately touched off a serious, though of relatively short duration, price-cutting war in several major cities, particularly New York, and evoked considerable press comment to the effect that fair trade pricing was doomed. Indeed, shortly after the decision, the nonsigner provision of two fair trade acts was declared unconstitutional by the highest courts of the respective states even when applying to intrastate commerce,[16] and it seemed probable that other state courts would follow in the same path.

The McGuire Act. To remove the disabilities of the Miller-Tydings Act, especially the one referring to the nonsigner clause of the fair trade acts

[15] *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U.S. 384.

[16] *Seagram Distillers Corp. v. Greene, Inc.*, Fla. Sup. Ct. 1951; and *Calvert Distillers Corp. v. Sach's*, Minn. Sup. Ct. 1951.

of the various states as interpreted by the majority opinion of the United States Supreme Court in the Schwegmann case, Congress passed a new federal fair trade law. It is known as the McGuire Act and it became effective on July 14, 1952. The new law, however, goes beyond that. It is stronger than the Miller-Tydings Act in several important respects. This strength issues from the more specific language used, from the deliberate attempts made to overcome certain of the defections in the earlier law itself or in the way in which it was interpreted by some of the courts. All this is clearly evident from the following principal features of the McGuire Act:

1. While it is an amendment to Section 5 of the Federal Trade Commission Act, it exempts vertical price-fixing agreements under the state Fair Trade Acts, by specific reference, from *any* of the federal Antitrust Acts.

2. Instead of confining the language to minimum prices as in the Miller-Tydings Act, it also legalizes contracts or agreements prescribing stipulated (absolute) prices as well as those that deal only with minimum prices.

3. It removes all doubt as to whether a manufacturer or other brand owner may, if allowed by state law, require a vendee to enter into such an agreement with his customers in order to make the established minimum or absolute resale price effective. While the Miller-Tydings Act was silent on this point, the new law specifically legalizes it.

4. It specifically legalizes the nonsigner clauses of the state acts by providing that a vertical price agreement is binding "whether the person . . . is or is not a party to such contract or agreement," thereby nullifying the effect of the Supreme Court ruling in the Schwegmann case.

5. It provides that neither the contracts or agreements in question nor any rightful action taken to enforce them "shall constitute an unlawful burden or restraint upon, or interference with, commerce." As the word commerce in federal legislation refers to interstate commerce, this provision was apparently designed to overcome the court decision in *Sunbeam Corporation v. S. A. Wentling* respecting the burden on interstate commerce which tended to favor such concerns as mail order houses. Whether such intended purpose will thus be achieved will depend upon future court rulings as to the constitutional limitations of this provision. It should, however, render impossible such decisions as that handed down by the Supreme Court of the state of Michigan on June 27, 1952, in *Shakespeare Company v. Lippman's Tool Shop Sporting Goods Company* to the effect that even intrastate transactions under the fair trade law may affect interstate commerce and hence come under the inhibition of the Sherman Act.

Administration of Price Maintenance Laws. To administer laws which so deeply affect the price structure is indeed a herculean task. The difficulty is accentuated by failure of the laws to provide the necessary enforcement machinery. To enforce these laws requires a tremendous amount of polic-

ing. The multitude of stores which are bound by intrastate contracts must be informed of the prices established and of all price changes as they are made. Fair Trade Committees organized by various trade associations have undertaken this task, but they have no legal status. Furthermore, they must depend on information of violations to be provided voluntarily by members of the trade. In general, the duties of such a committee are: (1) to negotiate with manufacturers for contracts, (2) to prepare and distribute minimum price lists to all outlets in the state, (3) to act as a clearing house for reported violations, (4) to notify violators of the Act, the contract, the stipulated price, and the alleged violations, (5) to investigate cases for litigation and make settlements, and (6) to collect and disburse contributions for enforcement. In some states elaborate organizations have been formed, consisting of the State Fair Trade Committee, city committees, key men in counties, and field representatives to check on the key men.

If a violator persists in price-cutting tactics, it is usually necessary for the manufacturer to bring suit in order to secure compliance. This may be illustrated with reference to an Ohio case in which the manufacturer of Prestone antifreeze brought suit against a price-cutting retailer who sought to have the Ohio Fair Trade Law declared unconstitutional with regard to nonsigners. Several excerpts from the court decision are of unusual interest:

> This act, in substance, makes the price conditions embraced in the contract binding upon the persons not a party to the contract. It imposes a restriction on Prestone which runs with Prestone and is a condition under which it must be sold. . . .
>
> We believe this section of the Constitution grants to the Legislature the power to enact the legislation under attack. In the case before us, the defendant
>
> 1. Purchased the Prestone in legitimate channels.
> 2. Had full knowledge of the restrictions at the time of purchase and, therefore, was not an innocent purchaser for value.
> 3. Sold it at less than the minimum price.
> 4. Had due notice of the agreement as to price.
> 5. Sold it knowing of the restriction and did so willfully.
>
> This is a commodity bearing the trade mark name, "Prestone," and such brand name carries a good will which has been established at great expense by the producer and belongs to the producer. The primary object of the injunction sought is to protect the good will of the producer which it still owns.
>
> There is a distinction between the physical commodity itself, which the defendants own and for which they paid the purchase price, and the good will, which remained the property of the plaintiff, and which it never sold, and which the legislative act is designed to protect. . . .
>
> Our finding and decree is for the plaintiff and a perpetual injunction is granted as prayed for.[17]

[17] *Union Carbide and Carbon Corp. v. Bargain Fair, Inc., et al*, State of Ohio, Lake County, in the Court of Appeals, Seventh District, Case No. 568, 1956.

Another aspect of enforcement is that a manufacturer who desires to pursue a policy of effective resale price maintenance must be prepared to enforce this policy generally; he cannot confine his enforcement proceedings to limited areas, particular sellers, or unusual conditions. While fair trade legislation does not define the duty of a manufacturer with respect to enforcement, neglect of violators over a period of time may, according to judicial rulings, deprive the manufacturer of the right to avail himself of enforcement proceedings. As explained in one court decision, "where price-cutting is so general and long continued as to indicate that the producer has waived or abandoned his rights under the statute and the price-fixing contracts, an injunction against one price cutter will be denied."[18]

Effects of Fair Trade. Experience with fair trade pricing from the time that such laws were first enacted to date leads to certain conclusions regarding the business, economic, and social implications of this type of legislation.

First, it is evident that the principal beneficiaries of this legislation have been independent retailers and wholesalers who serve them. For them the market is protected in some measure against the attacks of price cutters. Their margin on fair-traded commodities is in a way recognized by law, and their position is somewhat more secure. This applies, of course, only with respect to items for which fair trade prices are actively enforced. When a manufacturer merely "goes through the motions" of establishing a fair trade list price, and manifests no interest in maintaining it throughout his channels of distribution, the practice actually invites widespread discounting or price cutting.

Second, since the fair trade laws apply only to trade-marked or branded goods, they have had no effect upon manufacturers who produce non-branded merchandise or those who produce merchandise which is sold under the private brands of distributors.

A third conclusion is that fair trade gives the manufacturer of well-known and highly advertised brands better control of his market and secures for him greater cooperation of wholesalers and independent retailers, provided, again, that fair trade prices are actually enforced. One of the strongest arguments in favor of this type of legislation has been the allegation that price cutting disorganizes the manufacturer's market, cripples his good will, interferes with proper distribution, and fails to provide for the independent retailer the necessary margin to secure his cooperation in the display and sale of his goods. If these allegations are correct, the manufacturer is given a more stable market for his goods, as well as price peace and permanence.

[18] *General Electric Co. v. Klein-on-the-Square, Inc.*, New York Supreme Court, Special Term, Part IV, 1953.

A fourth conclusion, and one of very major significance, is that fair trade prices on branded convenience goods items, such as are commonly sold through drugstores, were generally not established at a high level, and that they resulted more in an averaging of retail prices than in a general raising of prices. Minimum prices stipulated by manufacturers tended to become the maximum and were widely observed as such by almost all types of retailers. Most manufacturers established this minimum at a level higher than the prices formerly charged by price cutters but lower than the prices set by independents and service retailers. The net effect then was somewhat of a leveling of prices, with the consumer paying more when purchasing fair-traded items at some chain and other price appeal stores but less when purchasing them from independent full-service merchants. This leveling may have proved beneficial to more consumers than the harm done through price increases by price cutters, particularly in cases where the number of customers served by service or independent retail outlets is greater than that served by price-cutting stores.

Fifth, when fair trade prices are set at a level that provides a margin greater than actually required for profitable operation by many outlets handling the product, the fair trade price is an open invitation to price cutting. As was pointed out in a previous discussion of discount houses (Chapter 11), fair trade prices established under conditions of limited markets for small and major appliances prior to World War II were continued under conditions of greatly expanded markets that prevailed in the late 1940's and early 1950's. In the latter period, when such items could be moved with less creative selling effort by the dealer, cut-price operations at substantial discounts from historic price levels attracted considerable patronage and, for many such dealers, resulted in a large volume of unit sales at a high rate of capital turnover and at a satisfactory rate of net profit return on investment. An unduly high fair trade price, experience has shown, tends to become a fictitious price—an umbrella that helps to call attention to the price cutter's operation.

Sixth, when fair trade prices are common in an industry, and manufacturers in that industry produce in quantities greater than will be absorbed by the market at established prices, the enforcement machinery for fair trade is not adequate to restrain the more powerful forces of supply and demand. This may be illustrated with respect to the market for major appliances in recent years. Although market demand increased substantially, production capacity for most kinds of major appliances was expanded at a very much greater rate, so that in the early 1950's there existed large amounts of excess manufacturing capacity. Each of a number of leading companies was seeking to attain a larger share of the total market and manufactured at levels of output that simply could not be moved through

existing channels of distribution at traditional prices. Natural economic forces resulted in a "spill over" of supply into new and then unorthodox channels, and consumers were able to buy at prices which were much lower than traditional fair trade levels.

Seventh, experience with fair trade has indicated that there are some lines in which legal resale price maintenance cannot be very effective. Several reasons may be advanced to show why such pricing has not been as important in the grocery trade, for example, as in the drug or liquor business. First, in the food trade, national brands are not quite as important as they are in drugs; and unlike the latter, a manufacturer's brand can be more readily replaced by a private brand. Second, so-called price cutters do a very large volume of business in the grocery trade, hence a manufacturer may be reluctant to cast his lot with the independent retailers and incur the displeasure of chain store outlets and of supermarkets. Some large chains, however, joined hands with independents in enforcing these laws in order to protect themselves against independent and local chains of supermarkets. Third, grocery prices are not rigid enough for price maintenance. They have to be changed frequently, making notification of price changes too expensive. Fourth, even with relatively few changes in prices, notification is an expensive proposition on account of the large number of outlets handling groceries. Finally, where chains are strong, private brands are important. Voluntary chains operating largely in the grocery trade have also placed much emphasis on private brands. Fearing such substitution, manufacturers are likely to be more reluctant to take advantage of the law in this trade than in certain other fields.

Another class of goods for which fair trade is not very effective consists of those commonly sold on the basis of trade-ins. When a dealer may offer almost nothing or a very substantial amount for a consumer's used product which is to be accepted as part of the purchase price, a manufacturer's list price can be little more than a suggestion of a reasonable retail value. It cannot be enforced as a fair trade price in any realistic manner. In the major appliance industry, sales strategy based on the acceptance of trade-ins became common in the late 1940's and early 1950's when markets had become relatively saturated; consequently, sales of new refrigerators or laundry equipment could be made in large volume only by selling to many consumers who already owned some type of similar item, perhaps obsolete in a design or style sense, but functionally operative. Expansion of trade-in retailing strategy, along with other market conditions mentioned above, led a number of companies to abandon fair trade pricing of major household appliances in the mid-1950's, although fair trade prices were commonly continued on small or so-called "traffic" appliances which are generally sold without trade-in complications.

Major Objections to Fair Trade. One serious objection to this type of legislation is the alleged tendency to freeze our distributive system and cause the inefficient to resort to more legislation of a protective nature. Insofar as this marks a departure from the old concept of free price competition, it is in the nature of a breakdown of that philosophy. Another objection is that price maintenance does not allow for differences in efficiency or for differences in the method of doing business. Once a price is established it applies to high-cost retailers and to low-cost outlets alike, to those that render a complete service and to those that operate on a self-service basis.

Price Regulation and Control

Unfair Trade Laws. From the foregoing discussion it is apparent that the so-called fair trade laws permit resale price maintenance in order to prevent price cutting below a specified point, regardless of whether the price cutting is purely predatory or on a profit-yielding basis Under them an owner of a brand is permitted to fix the price of his product in a contractual way. The so-called Unfair Trade Practices Acts strike more directly at predatory price cutting but do not affect price cutting made possible by efficient operation and which is conducted on a relatively profitable basis. For these reasons the unfair trade laws cannot be regarded as price-fixing measures in the same sense as are basing point systems and resale price maintenance.

No less than 30 states have enacted legislation of this character, under the title of "Unfair Trade Practices Act," "Unfair Sales Act," "Unfair Practices Act," "Unfair Sales Practices Act," or "Fair Sales Act." The constitutionality of these laws has been contested in a number of state courts. In a majority of instances, the laws have been upheld,[19] but in four states they have been found unconstitutional.[20] Consequently, by 1957 such laws were operative in 26 states. While similar in purpose, there is considerable variation with respect to terminology and specific nature of the prohibitions. All such laws prohibit sales below cost, but they fall into three general classes with respect to the manner in which cost is defined for purposes of enforcement.

In 17 states, cost for purposes of retail sales is defined as the actual or replacement cost of the goods, plus freight and cartage to the store, plus a markup to cover the cost of doing business which, in the absence of

[19] Constitutionality is well established within California, Louisiana, Minnesota, Montana, Nebraska, New Hampshire, Oklahoma, Tennessee, Washington, and Wisconsin.

[20] Arizona, Colorado, Maryland, and New Jersey.

proof of a lower cost, is specifically stipulated as some designated percentage of merchandise costs, usually 6 per cent.[21] Since all types of retail stores have average costs of doing business greater than this, retailers are still permitted to sell at prices which do not yield a net profit on each item sold; but on the other hand, at least some markup must be realized on each item. In seven states cost is similarly defined, but no statutory minimum markup is specified. Cost must include merchandise costs, freight and cartage to the store, and the retailer's own average markup, usually based upon his operating experience during the preceding six months of operation. Minimum legal prices are, consequently, somewhat higher than in the first group of states.[22] Finally, there are two states [23] in which the prohibition relates simply to sales below merchandise costs plus freight and cartage to the store without any markup requirement. Minimum prices are, of course, lower in these states than in the other two groups.

These statutes constitute a more direct attack upon predatory price cutting than that made by the fair trade laws. Furthermore, they are mandatory instead of merely permissive. Violation of such a law is usually punishable by fine or imprisonment, the penalty being imposed for each offense. Finally, these laws apply to *all* goods, whether trade-marked or not, and generally attempt to stop the wide use of *loss-leaders.* In addition to these "sales below cost" laws of general applicability, a number of states have similar legislation that prohibits sales below cost in the case of certain lines of trade or specific kinds of commodities. These apply in most cases to situations where loss-leader selling tactics have been an unusually severe competitive problem. Many of these laws deal with cigarette sales. Some deal with dairy products, bakery products, alcoholic beverages, or gasoline.

While the constitutionality of resale price maintenance laws has been established by United States Supreme Court decisions, such is not the case with respect to Unfair Trade Practices Acts. It may well be argued that such laws tend to destroy competition instead of encouraging it, and to fix prices to the detriment of consumers. Their defenders, on the other hand, claim that they are intended to prevent the destruction of competition by eliminating the unfair practice of cutting the price on some items even below cost of purchase and making up for the losses thus incurred by

[21] States with a minimum markup of 6 per cent above cost include the following: Connecticut, Idaho, Kansas, Louisiana, Maine, Massachusetts, Nebraska, New Hampshire, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Virginia, and Wisconsin.

The laws of the following states are of the same type but the minimum markup percentages differ: Pennsylvania, 4 per cent; and West Virginia, 7 per cent.

[22] States with laws of this type include the following: Arkansas, California, Kentucky, Minnesota, Montana, Washington, Wyoming. A common feature of these laws is that a retailer who is a member of a trade association that has made a cost survey for the line of business and the vicinity of operation may use the results of such a cost survey to establish his own cost of doing business for purposes of the law.

[23] North Dakota and South Carolina.

raising the price on other items. They further contend that these laws by no means freeze prices, since they permit variations based on differing original merchandise costs to retailers. But no matter how this type of regulation of prices may be regarded, it certainly marks a change from *laissez faire* and from the philosophy underlying antitrust legislation of the past. At the same time, however, it is definitely in line with the other thread in our philosophy, as expressed by the Federal Trade Commission Act and subsequent amendments, which requires that competition shall not be unfair and thus overflow the banks, to the ultimate detriment of the public at large.

Price Control. The several price-fixing policies discussed up to this point are those generally determined by individual sellers or, in the case of operation under the fair trade laws, by agreement of a vertical nature between a seller on the one hand and a buyer or buyers on the other To this there is but one possible exception, namely, operation under the Unfair Trade Practices Acts in which case a *floor* is set by the state government to prices that may be charged by retailers on the goods they place in their stores for resale. Even here no specific minimum prices are set by the state, each seller determining such prices for himself and varying them with variations in the costs of his merchandise from time to time.

During World War II, however, through the Office of Price Administration, familiarly known as OPA, widespread control was exercised over all sorts of goods and many services in the form of *ceilings,* and this was done by specifying individual prices on each and every item as *maximum* prices that may be charged by a vendor, although provisions were made for formula pricing, or percentage margins over costs, in instances where necessary to encourage production of essential items. The principal purpose, of course, was to use price control, along with the other forms of economic controls, as a method of preventing inflation during a period of extreme shortages relative to the demand for goods. Similarly, following the outbreak of the Korean War in the middle of 1950, widespread price control was re-established through the activities of the Office of Price Stabilization (OPS). Basing its plan largely upon the recorded experience of OPA, this office followed somewhat the same methods and practices, although it proceeded with greater flexibility than permitted under OPA ceilings partly because of the unknown, but suspected, long duration of the period of mobilization for which price controls were to be designed. It is undoubtedly sound national policy to exert control of this nature whenever serious shortages of vital commodities are threatened or actually occur, resulting in inflationary influences that are highly detrimental to national welfare. Except in time of war or other national emergency, circumstances in which such government action is advisable are rare indeed.

From this one might be led to believe that there is no danger whatever of any price control on the part of the government except in time of war or other great national emergency. The relatively successful price control experience during the war might prove tempting and lead to the use of some governmental price control here and there even in time of peace. True, the problem of price control at such times is likely to be one of *maintaining floors to prevent prices from sinking* rather than one of *providing ceilings to prevent prices from soaring.*

There is a strong tendency to bring various agricultural commodities within the scope of federal marketing agreements or orders for the purpose of controlling prices through volume limitations, allotment of purchase and sales rights among handlers, surplus or other pools, inspection requirements, filing of administered prices, and by other specified means.[24]

This may be illustrated with reference to fluid milk. Various areas have been declared as federal milk markets for the purpose of fixing prices for fluid milk to farmers supplying such markets and consequently necessitating the fixing of milk prices for distributors. Such markets are established under the provisions of the federal Marketing Agreement Act of 1937, as amended by the Agricultural Act of 1954, which provides that the price of milk, *along with various other commodities,* may be regulated by the Department of Agriculture. In order for a federal milk market to be established, interstate commerce must be involved and two-thirds of the producers, either by number or volume of production, must sign an agreement. When this is done, the Secretary of Agriculture, through properly designated regional authorities, is empowered to "fix prices as he finds will reflect such factors" (specified economic conditions affecting market supply and demand), "insure a sufficient quantity of pure and wholesome milk, and be in the public interest." Prices are generally set through the application of formulas that provide for automatic changes in existing prices whenever stipulated conditions change. Most such formulas were originally based on the price of one or more manufactured dairy products such as butter, cheese, and evaporated milk. There is, however, a growing tendency to employ formulas which establish the price of fluid milk in relation to local or regional indexes of average wholesale prices or buying income. More than 50 federal milk marketing areas of this kind have been established and it is estimated that about one-half of the total fluid milk production is subject to such federal orders or to similar intrastate orders which are effective under the laws of some states. This kind of control is highly favored by farmers and farm groups and for that reason is likely to spread.

[24] For a detailed account of the kinds of orders and their effects, see George L. Mehren, "Place of Marketing Agreements in Stabilizing Farm Income," *The Journal of Marketing,* April, 1955, pp. 331 ff.

Questions and Problems

1. Define or briefly explain the meaning of the following terms:
   a) delivered pricing system
   b) basing point system
   c) zone delivered pricing system
   d) freight equalization plan
   e) freight absorption
   f) mill net return
   g) phantom freight
   h) resale price maintenance
   i) nonsigner clause
   j) price fixing
   k) price control
2. Give a number of examples of specific products that have commonly been sold according to some form of delivered pricing system. What major characteristics do most of these products have in common?
3. What are the principal economic arguments for delivered pricing systems? Against such systems?
4. Is the existence of a basing point system of pricing goods, in itself, conclusive evidence of monopolistic practices in an industry? Analyze fully.
5. When viewed from the standpoint of society, should a basing point system of setting prices be condemned or approved and encouraged? Explore and evaluate.
6. In determining whether a delivered pricing plan of a manufacturer resulted in discriminatory prices paid by buyers, should one give attention to the delivered price actually paid by the buyer or to the mill net return of the seller? How did the courts view this problem in the Staley and Corn Products cases and in the Cement Institute case? How has the Federal Trade Commission viewed the problem in more recent decisions handed down by it?
7. Explain how the fair trade laws are administered. How do they differ from the unfair trade practices acts in this respect?
8. Outline the legislative and judicial history of fair trade.
9. Discuss the significance of the Supreme Court decisions in the Corn Products and Staley Manufacturing cases.
10. A lower retail price should mean greater sales of a given product. In normal times, a manufacturer constantly strives to increase sales volume. Then why would a manufacturer favor resale price maintenance?
11. What is "fair" about "fair trade"? Analyze from the standpoint of the manufacturer, the wholesaler, the retailer, and the consumer.
12. If a state has already adopted a fair trade law, is it not mere duplication of legislation for this state to pass an Unfair Trade Practices Act? Explain.
13. Explain how the general nature of price control during periods of war and other national emergency differs from price control measures that have been pursued in time of peace.
14. Explain why the use of fair trade pricing has been more common for so-called drugstore items than for grocery store articles. Why has fair trade been more effective for small or traffic appliances than for major household appliances?

15. A manufacturer of a nationally advertised brand of tooth powder that regularly sells for 25 cents at retail finds that in too many cases his tooth powder is being used as a "loss leader," which eventually might lead to a general belief that 25 cents is too high a price. Explain how the manufacturer might control this price cutting. How also might the manufacturer indirectly regulate his price in the future to conform to changes in the general price level without disturbing the 25-cent figure?

16. In order to meet competition of chain stores, a retail drugstore owner kept his prices on various national branded items at the lowest legal price. Because of small buying power, this proved unprofitable for him. He decided to push a private brand to take advantage of the greater margin of profit offered. By what other ways might he have overcome this price-cutting problem?

17. An electrical appliance manufacturer decides to enter the washing machine field. He will make two different model machines and at least one ironer. Distribution will be effected through franchised dealers. In each state the company will maintain several representatives who will work with dealers, take orders, secure new dealers, etc. In planning this new program, the manufacturer is quite concerned with the matter of resale price maintenance. The brand name used on his other appliances has been widely advertised and is considered highly valuable to the company. There are several difficulties involved, among them is that arising from the fact that transportation costs are quite an item and thus have a direct bearing on any attempt to adopt a policy of uniform prices throughout the country. Is some form of resale price maintenance practical? Is it desirable? Discuss.

VII

CRITICAL APPRAISAL OF MARKETING AND ITS GOVERNMENTAL CONTEXT

35

COSTS, VALUE ADDED, AND EFFICIENCY

In our society there exists a great network of private and public institutions engaged in activities which are closely webbed and interrelated. A large portion of these institutions and their activities is economic, and a segment of this portion is classified as marketing. To determine the precise activities of this segment, to measure the costs of performing them, to ascertain the economic values thus contributed, and to measure the degree of productivity and efficiency involved in the contribution, is far from an easy task. It is, moreover, an area about which relatively little is actually known but also one about which a great deal is presumed by those who are most ignorant on the subject. As a consequence, much confusion and misunderstanding exists. Marketing, however imperfect and defective it may be in some respects, as is true of all segments of the economy, is criticized on bases for which there is no sound theory or empirical fact.

Fortunately, rapid progress is being made by scholars who are carrying on research in this area. To date, their accomplishments are not of such a character as to permit the statement of conclusive factual findings related to all implications suggested by the title of this chapter. It has been written, therefore, with a view to *emphasizing concepts,* so that the student may better understand the economic basis for marketing and be provided with a sounder framework for formulating judgments as to how well various segments of our economic system, or individual institutions within them, are carrying on the marketing task.

Nature of Marketing Costs. In line with the definition of marketing in Chapter 1, the costs of marketing include the costs of all business activities necessary to effect transfers in the ownership of goods and to provide for their physical distribution. In the broadest sense, this includes all production

costs except those entailed in the addition of form utility (extracting, growing, fabricating, and processing) to goods.

Because of the various ways of approaching the subject, it is advisable at the outset to clarify different concepts of "cost." The cost of any economic activity can be analyzed on the basis of *costs and profits accruing to businesses* as a result of engaging in a given activity and referred to as *business costs,* or an analysis can be made on the basis of the *social costs* incurred.

The former approach requires a clear and precise concept as to the meaning of business costs. When arriving at the total costs of a business one must include *all* costs, both explicit and implicit. *Explicit costs* are generally of a contractual nature and include such expenses as salaries to employees, interest on borrowed money, rent, and taxes. In practice, these are generally charged against a business because they are obvious and definite in amount. *Implicit costs,* however, such as a reasonable wage to the owner for his services and a fair rate of return to him for the capital which he has invested in the business, are frequently not charged against a business. This is especially true of small concerns. As a result, the net profit figure under these circumstances becomes inflated. The term "operating expenses" as commonly used by accountants does not generally reflect the total cost of a business because usually they do not include all implicit costs which have been incurred. Economists have been more prone to consider implicit costs and to make allowances for them, even though it must of necessity be done on a rather arbitrary basis.

Social costs of any economic activity are numerous and not clear-cut. First and foremost, they include the time and effort which must be expended in accomplishing a given task. In connection with marketing, this includes not only the time and effort of people gainfully employed in the field, but also that of consumers spent in the process of obtaining goods. In addition to labor costs, one must include as social costs such things as deterioration of residential property values which result from an undesirable location of business establishments and various forms of tax-supported governmental assistance to special marketing interests. While pertinent, these costs are often impossible to measure and difficult to evaluate. *It therefore becomes necessary to make cost studies largely on the business cost basis,* with proper adjustments for profits or losses when determining the cost of a marketing activity to the ultimate consumer.

Nature of Value Added by Marketing.[1] The best measure of the output of an establishment, enterprise, industry, or other segment of the economy is the economic value added or contributed by it. Until about the mid-

[1] Portions of this chapter dealing with the value added concept have been adapted in substantial measure from writings and addresses on the subject by one of the authors. See especially Theodore N. Beckman, "The Value Added Concept as Applied to Marketing and Its Implications," in Stewart H. Rewoldt (ed.), *Frontiers in Market-*

1950's, use of the value-added concept has been more or less restricted to the field of manufacturing and even there only for general or over-all measurement.

The nature of the concept may be illustrated with reference to the manner in which it has been used in the Census of Manufactures for over a quarter of a century. As stated in its various publications, "Value added by manufacture is calculated by subtracting the cost of materials, supplies, and containers, fuel, purchased electric energy, and contract work from the total value of shipments." It thus represents the difference between the selling value of products shipped or delivered and the cost of materials, supplies, and containers, plus the cost of fuel, purchased electric energy, and contract work. Basically then the difference represents the *net value* of the operations of the reporting establishment itself, without any admixtures of economic values created in other establishments, and hence is presumed to measure the value added by the processes carried on within or the services rendered by the reporting establishment.

Theoretically, the treatment of the value-added concept by the Census of Manufactures is functional in character, since it is presumed to measure the contribution made by the *process* of manufacture as contrasted with the process of marketing or any other process. Actually, however, the concept is treated institutionally in that the value added by manufacture is computed on an establishment basis and thus covers *all* activities performed by the manufacturing establishment, including marketing activities to the extent performed by it. An institutional or establishment approach to the gathering of such information on a broad scale by government or trade association facilities appears inevitable under existing conditions. Hence, it appears practically impossible to attempt to measure the value added by manufacturing activities per se, as distinct from marketing activities.

It is nevertheless just as realistic to measure the value added by business establishments engaged primarily in marketing activities—especially the retail and wholesale trade structure of the economy. Ideally, this may be done in the same manner as for manufacturing establishments—namely, by subtracting from sales receipts the value of merchandise, supplies, fuel, purchased electric energy, and contract work bought from other business organizations. The result is, as in the case of value added by manufacture, a measure of the net contribution of the particular establishment making the calculation. Since most marketing establishments have only negligible amounts of outside contract work, and because the cost of supplies and

ing Thought (Bloomington: Bureau of Business Research, Indiana University, 1955) pp. 83–99; "Value Added as a Measurement of Output," in *Advanced Management*, April, 1957; and, "Value Added by Distribution," in proceedings of the *Twenty Eighth Boston Conference on Distribution* (Boston: Retail Trade Board of the Boston Chamber of Commerce, 1956) pp. 43–47.

electric energy is normally a small proportion of total costs, the gross margin of such establishments (sales receipts less landed cost of goods sold) is a close approximation to actual value added that might be used in the absence of the more accurate data.

The word "value" as used in the expression "value added" is employed in the same practical or business sense as it is used in the value of sales or value of shipments. To be sure, there is also a fundamentally subjective quality involving satisfactions to human beings mainly as consumers and can be truly known only to the human being involved, assuming full consciousness on his part of the character of all his satisfactions. To use the expression in the market-place manner here employed is not to assert that all business activities that create salable value also necessarily and in every instance add to the well-being of consumers. Certain business activity can be wasteful or destructive when evaluated subjectively, but there is no way of measuring such subjective satisfactions or dissatisfactions and their intensities, except through expressions in the market place in the form of prices. It is assumed that the price a person will pay for a product or service is in general a reasonable measure of its value to him. This assumption is realistic for purposes of measuring value added under conditions of workable competition, where almost all consumers have a wide range of alternative choices for the satisfaction of most of their wants or needs, and sellers are not in collusion with one another but actually compete.

Also, the term value added is used in the same sense as value created or value produced. This is in line with the best current economic thinking that production is the creation of economic values and that such values are created through the addition of utilities. As pointed out in Chapter 1, there are four classes or types of utilities; *form* utility which is created in any extracting, processing or manufacturing operation, and *place, time,* and *possession* utilities which are contributed through the performance of marketing functions.[2] This means that whoever creates any of these utilities is engaged in production, so that a wholesaler or retailer who normally creates place, time, and possession utilities is as much a producer as is a processor or farmer who is primarily responsible for changes in the form of the product. It also means that all who are engaged in the creation of utilities or economic values are productive and, by their work, add value and make a contribution to our economy.

Reasons for Emphasizing Value Added. There are several important reasons for applying the value-added concept to marketing. First, value added is the best available *absolute measure* of the contribution of our marketing system. It is a net figure, devoid of the duplication that is involved in the use of data on sales. Second, it is the best available *relative* measure

[2] It is suggested that the section in Chapter 1 entitled "Marketing, Production, and Economic Value" be reviewed in connection with the current discussion.

that can be used for making comparisons of the contribution of one marketing institution with another or of marketing institutions as a whole with those of manufacturing, agriculture, or other segments of the economy.

Third, use of value-added data helps to view costs in proper perspective. While cost is a measure of *input* or of what a business spends or puts into its activities, value added is a measure of the *output* produced by such costs. To look at costs by themselves, without knowing what was obtained for them is ludicrous, but that is exactly what is done when one looks at or condemns the cost of marketing without regard to the value created by it.

Fourth, as indicated in a following major section of this chapter, data on value added by distribution should serve to promote research for the effective determination of productivity and efficiency in marketing.

Fifth, more widespread attention to the value-added concept would necessarily result in improved public relations for institutions engaged in marketing. Among many people the idea prevails that manufacturing and agricultural industries add values and are productive, whereas marketing adds costs and is wasteful. As has been done in manufacturing, use of a value-added approach would tend to shift emphasis from a negative to a positive approach to the problems of marketing.

Sixth, application of the value-added concept to marketing would tend to emphasize the productive character of marketing functions and the productiveness of the persons engaged in their performance. Various implications of this consideration have been ably stated by one of the nation's most respected marketing scholars, as follows:

> The discovery that value added by marketing is as real qualitatively and as important quantitatively as value added by manufacturing and extraction thus represents a striking change in our ways of thinking about marketing. It cannot fail to have important consequences upon our future judgments of what marketing is supposed to do for us and how well it does it. . . . As historians and analysts we can devote our efforts to seeing what the nature and amount of its contribution is. As managers and consultants we can emphasize efforts to enlarge and enrich it. The effect upon both the study and the practice of marketing cannot, in my judgment, fail to be sweeping.[3]

Value Added versus Cost. Because "value added," which suggests utility and satisfaction, is closely related to the concept of "cost," which suggests disutility, some misunderstandings have arisen about the application of the value-added concept to marketing. Certain distinctions may be indicated and limitations pointed out.

In the case of an individual marketing firm. costs incurred for operations and value added are likely to be closely related but are not the same. To compute the value added it is necessary to subtract from sales receipts and all other revenues the cost of merchandise sold, the cost of supplies,

[3] Reavis Cox, "The Outlook for Costs Imposed and Values Added by Distribution" in proceedings of the *Twenty-Eighth Boston Conference on Distribution, op. cit.*, p. 48.

fuel, electricity, and contract services obtained from other firms. If the organization is operated profitably, the amount of value added (output) will be greater than such intrafirm costs which have been expended (input). The amount of value added can be less than the residual cost, which would indicate that customers are not willing to pay a price for the firm's services that will cover the cost of providing them. Such a firm would operate at a loss, and could not remain in business in the long run except by increasing the ratio of "value added" to "cost incurred."

From an aggregate social viewpoint and in the long run, costs or input items (in terms of labor, entrepreneurial management, land, and capital) are necessarily balanced with output or value added. The difference, socially, is the manner in which an economic aggregate is perceived, whether in terms of costs expended or benefits derived. Both points of view are essential for a balanced perspective, and neither one should be permitted to obscure clear thinking with respect to the other. It would be erroneous to conclude that marketing viewed in terms of "value added" should cause us to be concerned about ways and means of increasing it for its own sake—i.e., just to make the "value added" figure larger. It would be just as erroneous to assume that marketing viewed in terms of "cost" should cause us to be concerned with ways and means of reducing it for its own sake and without regard to the values obtained for such cost.

Measuring Marketing Costs and Value Added. Marketing costs may be measured in different ways, depending upon the objective of a given study of the subject. It may be the purpose of a study to measure the *nation's total marketing costs* for a given period of time or merely to determine the cost of marketing a *certain commodity* or a *certain line of goods* in the United States as a whole or in some particular area. Furthermore, some studies are concerned with the cost of performing one or several of the *marketing functions,* whereas others deal solely with the cost of a given *marketing enterprise* or of a specific type of *marketing institution.* As is pointed out later, a useful measurement technique for one type of study may prove wholly unsatisfactory for another.

As indicated above, the measurement of value added by marketing does not differ from the measurement of marketing cost when the approach is from the aggregate or social point of view. Since the discussion in the following paragraphs is concerned primarily with aggregates rather than with the determination of costs as related to problems of management within individual firms, the methods described may be considered as serving either objective.

Problems Encountered. There are certain problems which are common to all of the types of studies mentioned above. One of these problems is the fusion of marketing and other activities, as in the case of a manufacturer

who markets his products. At times this requires a rather arbitrary decision as to how a given activity should be classified. This fusion within an institution tends to complicate the task of charging marketing activities with their correct proportionate share of costs and profits. Many indirect costs can be allocated only on a somewhat arbitrary basis; and it is frankly impossible to allocate profits as between the manufacturing and the marketing activities of a given firm.

Another problem which is common to all research but especially acute here is that of obtaining adequate data. If data are available, they are frequently not in usable form. Many data cannot be obtained because of their confidential nature, and the expense connected with gathering certain cost information may prove prohibitive.

Major Methods of Measurement. There are three major methods of arriving at the costs of or values added by marketing: (1) consumer prices less form utility costs; (2) sum of gross margins of marketing agencies; and (3) functional approach.

Consumer Prices Less Form Utility Cost. One method of determining costs of or value added by marketing is by subtracting the costs of form utility production from the prices paid by consumers. The difference roughly represents the cost of marketing. In principle one must first ascertain the total amount spent by consumers during a given year for goods bought at retail stores and from nonstore sources of supply. Next must be determined the value contributed by original producers, including farmers, mine operators, oil well companies, lumbering concerns, and all others who produce raw materials. The value added by manufacture is then combined with this figure, the resulting total representing the cost of form-utility creation. This latter figure is then deducted from the amount spent by consumers. The difference approximates the cost of or value added by marketing.

This method is more complex and less satisfactory than appears on the surface. One reason is that more or less goods than are produced during a given year may be consumed, the difference being accounted for by inventories carried. But more important is the fact that the cycle of manufacturing is long and the process is roundabout. A very large proportion of raw materials and manufactured goods is not intended for ultimate consumption, but for industrial use. Comparisons of total form utility costs with total prices paid by consumers in any one year are, therefore, vitiated. This is still further complicated by the fact that many goods are bought by consumers in connection with professional or other services and not from regular retail establishments or from manufacturers. For example, goods obtained from beauty parlors, shoe-shining places of business, or garages are of this type. Retail and wholesale establishments also do a certain amount of processing or form utility work.

This method of marketing cost determination is more applicable to specific commodities or related groups of commodities than in figuring the total marketing bill, and is usually done on a sample basis. The weighted average retail price for the product under investigation is determined. For products that are processed all such costs, including the costs of raw materials, are determined and then deducted, the resulting figure being the cost of marketing.

Very often, though erroneously, the procedure is simplified by deducting from the retail price the price paid to the original producer, say, the farmer, and the remainder is alleged to be the cost of marketing. Illustrative are the annual "marketing margin" studies made by the U. S. Department of Agriculture, as shown in Table 23. Use of the term "marketing margins" in studies of this kind is very misleading and tends to give a distorted picture of marketing costs for the commodities included.[4]

In reality the matter is much more complicated, for the product may undergo several changes in form, as is true, for example, in the case of canned tomatoes. There is, first, the cost of original production of the raw product on the farms. To this cost must be added expenses incurred in canning the product, including the cost of the can itself. In the case of grain there may be even more production processes before it reaches the ultimate consumer in the form of bread or cake. Grain must first be produced on the farm, then converted into flour, and finally baked into a finished product. This means that in order to arrive at the proper costs of distribution it is necessary to ascertain: (1) the total cost of the various processing operations, together with the costs of original production, all of which in themselves contain some marketing costs, like transportation, and (2) to deduct the amount thus arrived at from the prices paid by consumers for the finished product. As a further complication, the finished product contains numerous ingredients for each of which it becomes necessary to calculate form utility costs as distinguished from the cost of marketing.

This should not be interpreted as a blanket condemnation of the type of study illustrated in Table 23. A useful purpose may be served by ascertaining the margins or spreads between farm value and retail value, even though common sense dictates that it would be better to use some term other than "marketing margin" to describe this spread. From a knowledge of year-to-year variations for farm products as a whole and for specific classes of products, the welfare of agricultural interests, as distinguished from that of marketing and manufacturing institutions, may perhaps be appraised and

[4] Cf. Theodore N. Beckman and Robert D. Buzzell, "What is the Marketing Margin for Agricultural Products?" *The Journal of Marketing,* October, 1955, pp. 166–68; also, Harry C. Trelogan and Kenneth E. Ogren, "What is the Marketing Margin for Agricultural Products? A Rejoinder," *The Journal of Marketing,* April, 1956, pp. 403–6.

evaluated and the data therefore may serve as *one* guide to public agricultural policy.

Even for such uses, however, the data are subject to serious criticism. First, there is the implication that manufacturers and other processors are middlemen. Second, the cost of marketing is grossly exaggerated. Third,

TABLE 23

RETAIL VALUE, FARM VALUE, AND "MARKETING MARGINS" OF AVERAGE ANNUAL PURCHASES OF FARM FOOD PRODUCTS FOR A WAGE-EARNING FAMILY

UNITED STATES, SELECTED YEARS

	Amounts			*Per Cent of Retail Value*	
Year	*Retail Value*[a]	*Farm Value*[b]	*"Marketing Margin"*[c]	*Farm Value*	*"Marketing Margin"*
1915	$ 267	$118	$149	44	56
1920	567	244	323	43	57
1925	442	186	256	42	58
1930	422	163	259	39	61
1935	347	134	213	39	61
1940	319	127	192	40	60
1945	459	246	213	54	46
1950	924	432	492	47	53
1951	1,026	495	531	48	52
1952	1,028	482	546	47	53
1953	1,002	450	552	45	55
1954	985	427	558	43	57

[a] For 1915-45, based upon quantities of farm-originating food products equivalent to the 1935-39 annual average purchases per family of three average consumers. For 1950-54, based upon quantities equivalent to 1952 average annual purchases per wage-earner and clerical-worker family. Retail value reflects average prices paid by consumers throughout the United States. Since the components and weights of the "market basket" were substantially revised for the years beginning with 1950, the dollar amounts (but not the percentages) are not comparable with those for the earlier years.

[b] Farm value is calculated from official series showing prices received by farmers applied to quantities of farm products equivalent to retail purchases and is adjusted by subtracting an imputed value at the farm level for nonfood by-products obtained in processing.

[c] Marketing margins are the spread or difference between retail prices paid by consumers and prices received by farmers, less imputed value of by-products. *These margins include manufacturing and processing costs for all products that undergo a change in form between the farm and the consumer and hence are not in reality "marketing" margins.*

Source: U.S. Department of Agriculture, *Agricultural Statistics* (Washington, D.C.: Government Printing Office, 1949 ed., p. 619; and 1955 ed., p. 461). Similar data are also available in this source for the following six major commodity groups: meat products, dairy products, poultry and eggs, bakery and other cereal products, fruits and vegetables, and miscellaneous food products.

it is questionable whether the farmer's share of the consumer's dollar is a good measure of his well-being. Fourth, it does not take into account the changed ways and forms in which farm products now reach the consumer. Finally, judgment on whether the farmer's share of the consumer's dollar is high enough, even when all other things are considered, depends upon the point of reference. For example, as shown by the data in Table 23, the

farmer's share has been going down from 1951 through 1954, but the 1954 share was as high as the share in 1920 and higher than the share was in both the 1920's and the 1930's.

Limitations of this Method. Certain weaknesses of this method may be summarized. In the first place, it is best adapted to a study of specific products rather than lines of trade or the entire range of commodities as a whole. Second, if intermediate manufacturing and processing costs are properly segregated, the method is very expensive. For these reasons, it is almost prohibitive to study a large enough number of commodities as a basis for generalizations. Third, even a given product may be distributed through several different channels and by different sales methods; hence, to obtain accurate information on distribution costs of such a commodity, an adequate sample must be obtained of prices charged for it when distributed by each of the different channels and methods and to weight each price according to the volume moved by each channel and by each sales method. Fourth, to separate manufacturing or other processing costs from those of marketing it may be necessary to secure access to the books of the manufacturers. Private investigators can seldom do that, but agencies like the Federal Trade Commission either may obtain such cooperation or utilize their legal power to obtain the figures which make a separation of costs possible.

Gross Margins of Marketing Agencies. A second method of ascertaining the costs of or value added by marketing in an *approximately* correct manner, at least from an institutional point of view, is by adding the gross margins (which consist of operating expenses and net profits) of the various agencies involved in the marketing process. To determine *total* costs of marketing by this method, the following procedure would be used. Suppose that in some given year total sales of all retail establishments are $175 billions and that estimated average operating expenses for all stores are 24 per cent. Total retail expenses would then be $42 billions. If in the same year, total sales of wholesale establishments were $240 billions and average operating expenses were 10 per cent, then costs in this part of the marketing structure would be $24 billions. If it is further determined that sales from factories amounted to $270 billions and that marketing costs in this case amounted to an average of 12 per cent, then marketing costs in this segment would be $32.4 billions. The three costs figures total $98.4 billions.

When this approach is used, it does not yield the total cost of marketing, because *net profits* of retailers and wholesalers, and that part of the net profit of manufacturers which may be attributable to their marketing operations, are not included. Neither does this figure include certain transportation costs as when goods move to the factory, from the factory to the wholesaler, or from the wholesaler to the retailer unless free delivery is given by the vendor in which case the cost of delivery becomes a part of

his operating expenses. Further, this figure includes as a marketing expense the cost incurred by wholesalers and retailers in the limited processing activities which they may perform, but it does not reflect the marketing costs of such enterprises as farms and mines.

The same procedure may well be used in determining the marketing cost of any line of trade, but it is more difficult for a study of such costs for a specific product. Following this method, it is necessary to ascertain the normal channels through which a certain commodity or line of merchandise moves from processor to consumer. The total of the margins received by the different agencies in such a chain of distribution presumably represents the cost of marketing. From the wealth of cost information which is now available, as explained in a following section, it is possible for a manufacturer to determine what it costs to move his products through wholesale channels and what it costs to retail them through stores. While such cost studies can only yield approximations, and separate allowance must be made for transportation costs, they can be made in a reasonably accurate manner for policy formulation purposes. They are, for example, an important factor in policy decisions relating to alternative channels of distribution.

The gross margin approach has been used most commonly in efforts by government agencies, research organizations, and individuals to measure total marketing costs and costs by different lines of trade or distribution channels. The United States Department of Agriculture regularly makes studies which reveal what part of the total final value of farm-originating consumer products is accounted for by the margins of various marketing agencies, such as assemblers functioning between farm and processors, and wholesalers and retailers operating between manufacturers or processors and the ultimate consumer.[5] This approach has also been widely used in distribution cost studies made by the Federal Trade Commission, the National Bureau of Economic Research, and some other prominent agencies.

Illustrative data from one of the most comprehensive available studies are presented in Table 24. This study was carried on, in part, by obtaining annual gross margin information from varied sources for each of a large number of lines of trade or kinds of marketing institutions. For each kind of outlet, the retail margin has been combined with the wholesale margin, where applicable, to determine the proportion of the final value that is contributed by the services performed by such marketing agencies. These data roughly measure value added by marketing only for finished consumer goods, from the time that they enter the distributive stream at factories until taken from it by ultimate consumers at the point of final purchase.

[5] See, for example, U.S. Department of Agriculture, Miscellaneous Publications: No. 710, *Beef Marketing Margins and Costs,* February, 1956; No. 711, *Pork Marketing Margins and Costs,* April, 1956; No. 712, *Marketing Margins for White Bread,* March, 1956; and No. 733, *Marketing Costs and Margins for Fresh Milk,* October, 1956.

They do not include values contributed by marketing functions within the industrial marketing sector of the economy.[6]

TABLE 24

COMBINED RETAIL AND WHOLESALE MARGINS FOR COMMODITIES MOVING THROUGH SPECIFIED KINDS OF RETAIL OUTLETS: UNITED STATES, SELECTED YEARS

(Per cent of retail value)

Type of Retail Outlet	*1869*	*1899*	*1929*	*1947*
Grocery, independent	27.3	28.3	30.1	28.8
Grocery, chain	n.a.	19.0	21.5	20.5
Department stores	n.a.	29.4	36.6	38.7
Mail order	n.a.	24.4	26.2	28.0
Variety stores	n.a.	31.0	34.7	36.0
Apparel stores	29.3	34.4	39.2	40.9
Furniture, independent	37.3	39.0	49.5	44.9
Furniture, chain	n.a.	44.0	44.0	44.0
Vehicles	26.8	27.7	28.0	29.4
Filling stations	n.a.	25.0	27.3	29.1
Hardware stores	40.7	38.0	44.1	46.8
Drugstores	39.8	46.7	49.6	48.0
All groups[1]	32.7	35.4	37.0 36.6	37.4

n.a. = not available

[1] Total includes data for many lines of business in addition to those shown in this table. First figure for 1929 is comparable with data for earlier years, second figure is comparable with 1947.

Source: Harold Barger, *Distribution's Place in the American Economy Since 1869* (Princeton, N.J.: Princeton University Press, 1955), Table 26.

Some Precautions. Marketing margins are usually expressed in percentages. In doing this, care must be taken to express them as a percentage of the *selling* price of the commodities handled. Older methods of retail and wholesale accounting often based expense items on the cost rather than the selling price of the merchandise, but this has been largely changed.

Certain expenses of operation are always computed as a percentage of the selling price as, for example, some taxes, commissions paid to salesmen, discounts given to employees and others, and markdowns. The profit made on a sale is not exaggerated when this method of figuring expenses is used; 33⅓ per cent of cost, for instance, is equal to only 25 per cent of selling price. If a merchant confuses his methods of pricing and figuring expenses and bases markups on cost price and expenses on selling price, he will not receive an adequate margin. A grocer who knows that his expenses are 18 per cent of his sales and who desires to have a net profit of 2 per cent will not attain that result if he figures his markup (20 per cent) as a percentage of his cost price. In order to secure the same result he would have to use a markup of 25 per cent of the cost price. Otherwise he would sell an article costing 80 cents for 96 cents rather than for $1 and would receive 4 cents

[6] Cf. comment on "Value Added by Marketing," Chapter 2 of this text.

less for each article than he should receive in order to cover both expenses and net profit. But perhaps one of the strongest reasons why merchants should base their figures on selling rather than on cost price is that the leading merchants, trade associations, and research organizations follow that method. Unless the same methods of accounting are used, the operating results cannot be compared with the standards supplied by such agencies.

Another precaution that must be taken when expressing marketing costs in percentages is to figure them on the same base. Expense percentages for manufacturers, brokers, wholesalers, and retailers cannot be added together since the manufacturer's percentage cost is based on *his* selling price, the wholesaler's percentage is based on *his* selling price, etc. All percentages must be converted to a common denominator, usually the consumer's dollar which is equivalent to the retailer's selling price.

This may be illustrated by the procedure that would be used in measuring the cost of a grocery product sold by a manufacturer, through brokers, to wholesalers, thence to retailers, and finally to ultimate consumers. The retail gross margin, let us assume, amounts to 18 per cent of net sales, or 18 cents of every dollar received from the consumer, while the common gross margin for efficient wholesalers is assumed to be 10 per cent of their net sales. Since the wholesaler's sales constitute only 82 per cent of what the consumer pays, it may be concluded that the wholesaler's margin is only 8.2 per cent of the consumer's dollar, making a total gross margin for both wholesaler and retailer of 26.2 per cent. If the broker's commission is 2 per cent of his sales, this amounts merely to 1.5 per cent of the consumer's price. If the manufacturer's marketing costs plus transportation from the factory to the wholesaler is 15 per cent of his net receipts, this is equivalent to 10.8 per cent of the consumer's price. Aggregate margins between factory and consumer thus amount to 38.5 per cent, or the value of the commodity at the factory is 61.5 per cent of the final consumer price. These computations are summarized in tabular form, as follows:

	$1.00	Spent for the commodity by the ultimate consumer
less:	.18	(Retailer's margin of 18%)
	.82	Wholesaler's selling price
less:	.082	(Wholesaler's margin: 10% of sales, or .10 × .82)
	.738	Selling price through broker
less:	.015	(Brokerage fee: 2% of sales, or .02 × .738)
	.723	Manufacturer's net receipts, exclusive of brokerage
less:	.108	(Manufacturer's marketing cost plus transportation to wholesaler: 15% of sales, or .15 × .723)
	.615	Value of commodity at point of manufacture
	$1.00	less $0.615 = $0.385 marketing cost or 38.5% of price paid by the ultimate consumer

Again, it is to be noted that in this calculation only the expenses incurred in distributing groceries *after* they have been manufactured were considered. As a matter of fact, there are also important expenses involved in marketing raw materials which may go through several marketing agencies. In addition, the manufacturer must maintain an organization for buying these raw materials and also some semi-manufactured products, such as cans and labels. When all of these costs are added together there is but little doubt that 40 per cent to 50 per cent of the final value of many grocery items is used to cover the costs of essential marketing functions and to yield a profit to the various agencies involved.

As may be observed from data in Table 24, marketing accounts for a larger share of final value in most lines of trade than it does in groceries. Department stores alone have an average gross margin of about 35 per cent. To this must be added fees charged by commission houses, selling agents, or wholesalers, from whom they obtain some of their merchandise requirements. For a complete appraisal, one would also have to consider costs incurred by manufacturers in securing raw materials. These are bought from various types of sources whose expenses, in turn, also must be added to the net figure. Finally, there are local buyers of cotton, wool, and other products used in the manufacture of these goods, who frequently constitute the main source of supply to these supply houses.

Functional Approach to Marketing Costs. A third method of measuring and analyzing costs is by means of data regarding the costs of performing various functions. If it were feasible to collect cost data for each of the eight marketing functions, the sum would represent the total cost of marketing. Unfortunately, the cost records and accounting systems of different kinds and types of marketing institutions are not sufficiently standardized to make this a practical approach for measuring either total marketing costs or the costs of marketing specific commodities from production to ultimate consumption. Attempts have been made to compute total costs of advertising and transportation, but much more statistical data must become available before any reasonably accurate approximations of the total costs of the less specialized marketing functions can be made.

In measuring and analyzing costs of a given marketing institution or group of institutions, however, the functional approach is perhaps the most commonly accepted. With the advent of scientific accounting, businesses have classified their expenses along functional lines. Fortunately, the functional classification and subclassifications are highly standardized in certain types of business, making possible fairly accurate comparisons and consolidations as between firms. Many trade associations have collected functional cost data, some of which have been made generally available.

Most of the studies along this line have been limited to large types of establishments, such as department stores, departmentized specialty stores, and larger merchant wholesalers, where a functional breakdown of expenses is possible. For department stores the data are summarized for the following functions (also by some breakdowns of these functions): administrative and general, occupancy, publicity (sales promotion, advertising, and display), buying and merchandising, and selling and delivery. When an individual store or wholesale establishment keeps its own records according to the classification system used by a trade association for the purpose of preparing and publishing average or typical figures, meaningful comparisons can be made. Points of management weakness or operating inefficiency are revealed, and the specific nature of corrective action is clearly indicated. On the other hand, if a marketing institution knows only how its *total* operating expense ratio compares with other similar concerns, it still lacks factual information as to the best course of action to pursue in the event the comparison is unfavorable.

It would hardly be possible for the proprietor of a small store or wholesaling business to allocate such costs as his own salary into various functional classifications. Yet such studies, accounting at least for certain major functions as selling, delivery, credit, etc., have been made for hardware stores, grocery stores, and certain other lines of both retailing and wholesaling.

Total Marketing Cost and Value Added Estimates. There is considerable discrepancy in various estimates that have been made of total marketing costs and value added. Such studies have been made only sporadically and have been severely hampered by the limitations of available data and the difficulty of segregating the costs of marketing from those incurred in connection with form utility production. Estimates have varied from about 50 to 60 per cent of the total final (sales to ultimate users) sales value of all goods. The specific figure obtained in any particular study depends to a large extent upon what data are used, how they are arranged to obtain the total, and above all, what basis is used for expressing the total *amount* as a percentage, whether it be expressed as a ratio to *all* goods marketed counted once at f.o.b. point-of-production prices, as a ratio of all marketing *volume of business,* as a percentage of the goods bought by ultimate and other end users, or as a per cent of total economic value contributed by all segments of the economy.

Trend in Marketing Costs. Total marketing cost estimates of the type indicated above have given rise to many criticisms. Because the cost of performing essential or desirable marketing functions often equals or exceeds the cost of form utility production, blanket condemnations of the efficiency of marketing, or alleged lack of it, have been rampant.

The allegation that marketing costs are *too* high presupposes the existence of some objective standard against which actual costs, if they were exactly known, could be evaluated. Thus, at the outset the criticism is largely baseless, partly because of the lack of any suitable criterion of what costs should be, but more because of the lack of sufficient knowledge as to the exact status of marketing versus form utility production costs. Moreover, whether marketing costs are *too* high depends upon the nature of the services and functions performed in the distribution process, the need for them, the effectiveness with which they are being performed, and the net effect of such services and functions upon the various factors of production and consumption. If more service is given than is actually required by customers, if unnecessary functions are being performed, if necessary functions and activities are inefficiently executed, if the result of such operations is to increase the cost of production or to make consumption more difficult, then marketing costs could well be regarded as *too* high. In the absence of proof to these effects no conclusion is warranted that marketing costs are *too* high even when they are admittedly a large proportion of total value.

Regardless of the existing knowledge about marketing costs, it is quite apparent that the aggregate marketing costs have tended to increase throughout the history of this country, despite some arguments to the contrary when selected short periods affected by cyclical factors are considered. This is true whether such costs are considered in absolute amounts per unit of product sold or are appraised in relation to the final or retail value of goods marketed in our economic system. That this statement is true should be rather obvious to one who has carefully studied the historical material included in various places in this book. It may, however, be appropriate to state briefly some of the factors which have been responsible for this long-range upward trend.

One important reason has been the increasing geographic and occupational specialization in form utility production. As different regions concentrated on commodities for which they were best suited, and as economies of scale were realized in manufacturing as a result of the Industrial Revolution, it became necessary to transport goods over longer distances, store goods for longer periods, and to assume more risk because of the longer time and space spans between form utility production and consumption. A second and related reason stems from a changing institutional framework. When most goods were made for relatively local consumption, a large part of the marketing burden was assumed by the grower or maker. With more widespread markets and specialized manufacturing, a structure of specialized marketing institutions evolved. In the early days little attention was given to marketing costs, or they were presumed to be low, because they were fused or *con*fused with the costs of form-utility producers. Now marketing

costs are usually *explicit,* more easily recognized, and a greater amount of attention is focused upon them.

Third, the expansion of markets has made necessary large-scale demand-creation activities which were unknown in the days of handicraft production. Such costs loom large in absolute amounts and, in the case of many commodities, in relation to the value of goods distributed. The average consumer is very likely, however, to overlook the fact that such costs may be more than offset by manufacturing economies, arising out of the larger scale made possible as a result of advertising and personal selling effort. A fourth factor is the consumer's demand for services. Consumers have come to expect many services of retailing institutions which were unknown or relatively uncommon decades ago. Rest rooms, liberal adjustments, several types of credit service, delivery, air-conditioned stores, and pleasant and beautiful shopping surroundings are illustrative. It is often overlooked that such services result in satisfactions just as real to consumers as those which the products yield. Because such services are invariably supplied to the consumer in a marketing establishment, their cost is necessarily tied to the cost of distributing goods. Fifth is the consumer's demand for style and broad assortments of merchandise. Both form utility costs and marketing costs could be decreased if we were all content to wear a standard uniform. To the extent that we demand change and extensive assortments from which to choose, we demand more costly manufacturing (in smaller lots) and more complicated inventory, buying, and risk problems for retailing and wholesaling institutions.

From this brief discussion it should be apparent that total marketing costs can be appraised socially only in relation to the sum total of consumer satisfactions or values which are yielded by marketing activity—not in relation to the costs of form utility production which is a rather meaningless comparison. It should be obvious, moreover, that the costs of marketing can increase both absolutely and relatively with resulting enhancement rather than diminution in consumer values, partly because of the manufacturing economies which have been both a cause and effect of modern marketing effort.

Variations in Marketing Costs

Any scientific analysis which deals with variables must recognize both the central tendency of those variables and the deviations of individual observations from this central tendency. Applying this to marketing cost analysis, we must seek to discover not only *average* distribution costs for firms engaged in marketing activities, but must try to account for the *variations* from such an average. This is done in part by classifying institutions

according to common characteristics and accounting for differences between the average costs of institutions in each classification.

Variations by Level of Operation. As indicated in Table 25, there is a considerable variation between retailers' operating expenses and those of wholesalers for any given line of business. A retailer's operating expenses are generally higher for many reasons. His sales are in relatively much smaller units. This means, of course, that his number of customers is much larger for a given sales volume. These factors increase the cost of performing the functions of credit, delivery, and selling. Retail stores are generally located in higher rent areas. Expensive displays must be maintained. Advertising is also more costly, especially where wholesalers are not actively promoting private brands. In certain lines of business, such as floor covering or electric ranges, the retailer assumes greater installation and mainte-

TABLE 25

A COMPARISON OF TYPICAL OPERATING EXPENSES OF RETAILERS AND WHOLESALERS IN SELECTED LINES OF BUSINESS

Line of Business (arranged in order of magnitude of retailers' operating expenses)	Operating Expenses Expressed as a Per Cent of Net Sales	
	Retailers	Wholesalers
Florists	44.1	24.1[a]
Jewelry—primarily instalment credit	41.7	17.7
Jewelry—primarily cash, open credit	40.7	
Furniture	36.6	18.5
Gift, novelty, souvenir	35.6	24.2
Book stores	35.1	19.6
Women's wear	33.6	15.4[b]
Men's wear	31.5	15.4[b]
Appliance-radio-television	31.4	13.1
Children's and infants' wear	28.9	15.4[b]
Auto accessories and parts	28.7	24.4
Drugs	28.4	13.6[c]
Hardware	27.5	18.3[c]
Family clothing	26.7	15.4[b]
Sporting goods	26.6	17.8[d]
Dry goods, general merchandise	24.7	14.4[c]
Gasoline service stations	20.7	10.0[e]
Meat markets	19.3	10.3
Lumber, building materials	17.7	10.7
Liquor (package stores)	16.9	9.1[f]
Groceries	14.4	7.5[c]

[a] Flower, bulb, plant wholesalers.
[b] Clothing, furnishings, footwear wholesalers.
[c] General line.
[d] Amusement, sporting goods distributors.
[e] Petroleum bulk plants.
[f] Wine, distilled spirits wholesalers.

Source: For retailers' ratios: *Operating Ratios for Thirty-Five Lines of Retail Trade* (New York. Dun & Bradstreet, Inc., 1955). For wholesalers: *United States Census of Business, Wholesale Trade—1954*. (Note. all wholesalers' ratios are for the year 1954. Retailers' ratios are for 1954 in the great majority of cases, but in some instances are based on the most recent available ratios for the line of business.)

nance responsibilities. Generally speaking, he renders more services to his customers. Then, in some lines of trade, the wholesaler is able to shift certain functions forward to retailers or backward to manufacturers by selling drop shipments to retailers.

Variations Between Different Lines of Business on Same Level. Again referring to Table 25, a wide variation exists in the operating expenses of the different lines of business on the same plane of distribution. In retailing, for example, this table shows average operating expense ratios ranging from 14.4 per cent of net sales for grocery stores to 44.1 per cent for florists. While the scope of this discussion does not permit a complete treatment of all possible factors which account for these variations in costs, the more important are listed below:

1. Rate of stock-turn
2. Perishability of the goods
3. Seasonality of the merchandise
4. Style element
5. Seasonality of sale
6. Degree of processing or conversion
7. Installation and maintenance
8. Frequency of purchase by customer
9. Selling skill and attention required
10. Technical skill in selling
11. Value of the unit sale
12. Location—within city or trade area
13. Degree of competition
14. Extent of functional integration, and degree to which functions are shifted to institutions on another plane
15. Selling equipment used

All other things being equal, a line of business which enjoys a more rapid rate of stock-turn will enjoy a lower operating cost. Perishability, seasonality, and style element add to the cost of handling a given line. The cost of handling a line increases if processing, conversion, installation, and maintenance work must be undertaken. Regular and frequent purchases by customers tend to lower costs. Costs rise when increased technical skill, selling skill, and attention are required in making a sale. Other things remaining the same, relative costs vary inversely with the value of the unit of sale.

Certain lines of trade require the wholesaler or the retailer—especially the latter—to locate in more areas with high real estate or rental costs. A greater degree of competition in a given line of trade may have a favorable influence on costs, as necessity is frequently the mother of invention. If competition is so great that it keeps firms from approaching an optimum size and capacity, however, it may affect costs adversely.

In certain lines of trade it is possible for businesses to shift certain functions backwards or forwards. This will put the particular line of trade in a more favorable position with respect to operating costs. In some lines of trade there is greater integration of functions. Such integrated firms logically should show higher operating costs as compared to an establishment operating on a single level.

Certain factors which account for variations *within* a line, as discussed in the following pages, also apply to variations *between* lines of trade. In comparing the costs of different lines of trade, each of the above factors must be considered and weighed. The advantages gained by one factor may be greatly offset by the disadvantages of another.

Variations Within Same Line of Business on Same Level. There are also wide variations in the operating costs of firms which are in the same line of business and which operate on the same plane of distribution. In the retail grocery trade, for example, many full-service independent grocers have operating expense ratios almost twice as high as those of efficiently managed, large-volume supermarkets. In the department store field, to take a more specific example, 1954 operating results revealed that such stores with annual sales of $1 to $2 million had *average* costs of 34.5 per cent but that one-half of the individual stores in this group actually had expense ratios within the range of 32.05 to 36.35 per cent.[7] It is unfortunate that more cost studies do not reveal the degree to which the experience of individual firms varies from average or typical results.

Many of the reasons for variations between lines are also applicable to variations between firms within a given line. Other factors are:

1. Efficiency of management
2. Services rendered
3. Extent of the line of merchandise handled
4. Region of location
5. Size of business establishment
6. Size of city

While the effect of the first of these factors is obvious, the others merit some comment. Many types of services such as delivery, pretentious surroundings, liberal adjustment and return policies, and credit are popularly associated with relatively high operating costs. The influence of credit upon operating costs is, however, often exaggerated. In fact, the extension of credit often increases a merchant's sales volume out of proportion to increases in costs with the result that lower costs may be experienced after the inauguration of such a policy.

[7] Malcolm P. McNair, *Operating Results of Department and Specialty Stores in 1954* (Boston: Harvard University, Bureau of Business Research, 1955), Bulletin No. 143, Table 8.

In wholesale trade, specialization within a line has meant an increase in costs of operation; this is to be expected because such specialization tends to reduce the economic advantages of the wholesaler. Consequently, specialty wholesalers have higher costs of operation than do general-line wholesalers. The reduction of a line to only the fast-moving items, however, has helped the chain store to reduce its costs of operation.

Some cost factors vary among different regions of the country. The level of wage rates and availability of an adequate supply of qualified personnel is one example. Regional variances in consumer preferences for merchandise items and services have an effect upon the assortment and service offerings of vendors. The density of the market and the related expenses of advertising and physical distribution vary somewhat with the concentration of population within a region.

Other things being equal, relative costs vary with the size of firm. In the case of wholesale establishments, there are decreasing costs in most lines of trade. In retailing, however, the optimum size firm may be relatively small. In any event, size in itself becomes one criterion for cost differences between firms in a given line of trade.

Analyses of retail expense data for several trades have revealed that large stores in small cities usually have the lowest expense ratios. Classification of stores by city size alone almost always reveals that costs are lowest in small cities. When stores of different sales volume sizes are classed according to city population size groups, however, expenses tend to be lowest for the largest stores. Combination of these tendencies results in lower operating ratios for large stores located in small cities.

Detailed Cost Studies Essential. In order to glean the reasons for the numerous variations in operating expenses and determine the relative importance and controllable nature of various factors, more detailed breakdowns of expenses are needed, even though they be made on a sample basis. For some trades detailed operating expense studies have been made by trade associations, by certain University Bureaus of Business Research, and by other private and governmental organizations as explained at an earlier point in the chapter. A continuous analysis of such costs will contribute to our knowledge of marketing and thus furnish one of the keys to enhanced efficiency.

Efficiency and Productivity in Marketing

The concept of efficiency and its application to marketing is a subject of great interest to economists, businessmen, government officials, and informed consumers. Also of great current interest are various quantitative reflections of efficiency, as provided by different kinds of productivity measurements. Productivity analysis is, in fact, one of the most significant

conceptual tools available for the guidance of public policy and decision-making within the individual firm. Leaders in the field of business, organized labor, and government are in accord in their thinking that in the long run improvements in the average standard of living depend primarily upon increased productivity.

In spite of the great importance of the concept, only limited application has been made of it in the field of marketing. Most of the available studies of productivity have been made in other fields, especially manufacturing. Lack of adequate methods of measuring productivity in marketing, together with the somewhat common failure to recognize the productive character of marketing functions, has resulted in many unfounded and often prejudiced criticisms of the marketing sector of the economy. It is believed that greater attention to the productivity concept in marketing and to methods of measuring it will serve to dispel certain misconceptions, advance the frontiers of marketing thought, and contribute to greater efficiency in the long run.

Productivity and Economic Efficiency. In popular parlance, productivity is often confused with production. If the gross national product increases by a stated amount from one year to the next, it may be reported erroneously that this amounts to a given per cent increase in productivity. Production, which is the end result of economic activity, can increase without there being any increase in productivity, and, in fact, an increase in production can be accompanied by a decrease in productivity.

Productivity is a ratio of *output*—the results of production—to *input* for a given period of time. The ratio may be applied to the whole economy, a particular industry, a specific business enterprise, a department or work center within a firm, or an individual employee.

Economic efficiency is a related but more far-reaching concept. It implies some definite economic goal such as accomplishing of the greatest amount of work in the best possible manner with the least expenditure of time and resources. In fact, there is no such thing as efficiency in general or efficiency per se. What may be efficient when judged by one measuring rod may be quite inefficient when measured by a different standard. There is, for example, the *physical efficiency* which is measured by the relationship between quantity of goods produced and quantity of goods, labor, machine time, and supervision consumed. Then there is the *business or financial efficiency* measured by the relationship between dollars spent and income earned. There is also the *human or social efficiency* measured by the relationship between the human costs incurred and the satisfactions derived.

Consequently, productivity in marketing is desirable from a social viewpoint only to the extent that it enhances efficiency, as by creating maximum consumer satisfactions in a manner desired, and with the least expenditure of

time and resources—material and human. Furthermore, such results in relation to effort must be examined in the light of the ultimate objective and the time element. If a high degree of productivity in marketing should in the long run tend to result in recurrent crises, unemployment, human suffering, and a possible breakdown of our capitalistic, profit-motivated, competitive economy, a smaller measure of productivity could become more desirable. Thus, contrary to popular belief, productivity per se is not an end in itself and may not even be the chief desideratum. The extent to which it should be sought depends on the immediate and ultimate consequences. There is, however, ample room for improving productivity in marketing before reaching the point where the consequences of ultra-productivity must be considered.

Criteria of Marketing Efficiency. Marketing efficiency in the absolute may be judged by the *presence* and *extent* of certain major factors. One of them is specialization. It constitutes the very cornerstone of efficiency. Closely allied to it is the degree of standardization in the goods marketed and functions performed. A third factor is the extent to which labor-saving devices are utilized in the performance of the marketing task. A fourth factor is the dynamic nature of marketing—the ever-changing character of the system and its institutions. The degree and nature of competition is a fifth criterion by which to judge efficiency in marketing. Sixth is the kind and amount of research. Finally, there is the matter of the amount and quality of organized education and training for work in the field of marketing, both in the schools and universities and by business organizations.

Such a checklist of qualitative factors is helpful in determining the presence or absence of efficiency in the economy or a segment of it, in judging historically whether efficiency has increased or decreased, or in ascertaining what lines of trade or what business firms are probably more efficient than others. Such a qualitative approach can only be a starting point in efficiency analysis, for it lacks precision and definiteness; hence, there is much interest in efficiency, as reflected by various methods of measuring productivity in marketing.

Measurement of Productivity—Special Problems in Marketing.[8] A number of different approaches have been used in attempts to measure productivity in marketing. Before giving consideration to several of these, attention is directed to special problems of measurement.

One major problem arises from the intangible character of output in marketing. Marketing consists of certain types of productive activities or services. Tangible products for which specific physical services must be per-

[8] In this and the following sections acknowledgment is made of the results of research work of Robert D. Buzzell, from an unpublished manuscript, *Productivity in Marketing*, in progress under supervision of two of the authors as a Ph.D. dissertation at The Ohio State University, 1957.

formed are easily counted and, in many cases, must be enumerated for reasons other than productivity analysis. Examples consist of units, bushels, or bales of agricultural products which must be ascertained for purposes of determining storage fees or transportation charges. It is much more difficult to relate the services of buying, selling, financing, or marketing information to any specific measure of output, as can be done in agriculture, mining, or manufacturing where one is almost always concerned with the production of specific units of form utility. The lack of a natural or specific physical unit of output to be used in measuring marketing productivity is inherent in the very nature of things.

A second problem already mentioned in connection with methods of cost measurement and common to other segments of the economy is the interrelationship of marketing with other forms of production. Certain form utility functions may be performed in marketing institutions, and various marketing services are commonly rendered by manufacturing and agricultural producers; but the data are available only on an institutional basis. Over a period of time, there may be significant shifts in the character of the services performed in a particular segment of the economy. At one time, for example, it was common to package such items as sugar, dried fruit, and rice in retail grocery stores, and much personal selling effort was employed at the retail level in effecting sales to the consumer. Historically, packaging of such items has been shifted almost altogether to manufacturing establishments owned by companies that engage in brand name advertising, attempting to create a consumer preference for products sold under self-service methods. A change of this kind may, on the surface, indicate increased efficiency in food retailing, but the *net* economic effect is obscured unless attention is given also to the additional resources utilized in manufacturing or processing companies. In any historical studies, therefore, it is always essential to consider whether functions performed within a segment under analysis have been constant or have been shifted or fused with functions performed by other segments of the economy.

Minimum Cost Approach to Productivity. Historically the most common approach to the measurement or evaluation of productivity in marketing is one based upon the determination of marketing costs and comparison of such costs with some point of reference. This approach has been used from a social point of view, in regard to total marketing costs, as indicated earlier in this chapter. It is also widely employed by businessmen as a matter of internal cost control. As a general philosophy, this approach may be summarized by the naive statement "the lower the cost, the greater the productivity."

Critics of our marketing system have used this approach in lamenting the alleged fact that marketing costs exceed (as one point of reference) the

cost of form utility production, or that they exceed (as another point of reference) the level of marketing costs at some former period in time, or that they exceed (as a hypothetical point of reference) what the costs should ideally amount to in the judgment of the critic.

The cost approach is without any value whatsoever *for the purpose of measuring or evaluating productivity of marketing from a total or social viewpoint.* The reason for this, as previously indicated, is that the aggregate costs of marketing are the same as the aggregate of the market or salable values contributed by the marketing process. Dollar costs, which may be used as measures of input, are, from another viewpoint, the dollar contribution of the marketing system to total value.

The popularity of the cost approach undoubtedly stems from its use for cost-control purposes within individual business enterprises (or, perhaps to an even greater degree, to its use in household budgeting). Business managers quite naturally think of productivity in terms of minimum cost for some measure of output such as sales volume, gross margin, or physical volume of production. The social contribution of the cost approach stems from the manner in which competitive entrepreneurs apply it for purposes of internal management, thereby striving for greater efficiency within the firm which benefits the consumer in an economy of workable competition.

Quantity of Goods Marketed Approach. Another common approach to the measurement of productivity in marketing is one in which the physical quantity of goods marketed is considered to be the marketing "output." In simplest form, this approach would identify maximum efficiency with the minimum cost of marketing some physical product, say a quart of milk. It is apparent from this example that productivity, under this approach, would be judged in relation to the amount of marketing effort or cost expended, *per physical unit of product,* without regard to values created in the process of marketing the product.

Much more complex, but similar in concept, are measures of productivity in marketing in which output is represented by an index of manufacturing output or by an index of output in so-called goods-producing industries (manufacturing, agriculture, mining, etc.). Several authors have made such studies and data are available in them for the period 1869 to 1950.[9] As a general rule, this concept of output, after adjustment for change in

[9] Paul W. Stewart and J. Frederic Dewhurst, *Does Distribution Cost Too Much?* (New York: Twentieth Century Fund, 1939), pp. 378–79; Paul D. Converse and Harvey H. Huegy, *Elements of Marketing,* 3rd ed. (New York: Prentice-Hall, 1946) pp. 695–97; R. R. Giffin, "Changing Output per Person Employed in Trade—1900–1940," *The Journal of Marketing,* October, 1947, pp. 242–45; Nil T. Houston, *Methods of Efficiency Analysis in Marketing,* Unpublished doctoral dissertation, Harvard University, 1948, pp. 82, 114; Harold Barger, *Distribution's Place in the American Economy Since 1869* (Princeton, N.J.: Princeton University Press, 1955), Tables 6, 10, 12.

prices, is related to the number of persons engaged in marketing or to the number of man-hours worked by marketing personnel. The resulting expression of productivity becomes an index of the output of physical goods per person or per man-hour in marketing. Findings of such studies have varied considerably, even when similar methods have been employed, largely because of problems in obtaining suitable measures of the physical volume of output and reliable data on employment in marketing as distinct from employment in form utility production. In general, however, it has been found that productivity in marketing, *as so measured,* has not kept pace with productivity in the so-called goods-producing industries.

The major weakness of such studies is that they all involve the untenable assumption that marketing output is constant per unit of physical product over long periods of time, or, stated differently, that the marketing task varies directly with the comparative—the physical volume of form utility production. That this is unwarranted should be evident to any student of this book who has given attention to the effects of the Industrial Revolution, the changes in consumer wants and desires, and other factors previously discussed in connection with trends in marketing costs.

Measurement of Units of Functional Output. Since marketing consists of a number of basic functions or services, a conceivable method for measuring marketing output might be in terms of some measure of the number of units of output for each of the eight marketing functions. For example, buying and selling output could be ascertained in terms of number of exchange transactions; transportation in ton-miles; storage, in ton-months or perhaps cubic feet or yards per month; and so on. This is obviously impractical *from an aggregate point of view* at the present state of our knowledge. It is apparent that a transaction is not the same in one firm as in another, or on one plane of distribution as on another, and need not be the same in different periods of time. Furthermore, it would be extremely difficult to develop specific units of measurement for some of the functions such as marketing information and research or risk-bearing.

This approach is, however, the most significant currently used basis for meaningful productivity studies within business firms. As indicated previously, many large retail and wholesale companies compute their costs of operation in terms of functions which are basic within their respective organizational structures. In the most progressive accounting practice, such costs are further analyzed by the number of homogeneous units of activity performed and the cost per unit of activity. This may be illustrated with reference to the department store trade, in which it was formerly common to express all items of expense as percentages of sales. According to new accounting procedures adopted in 1954,[10] large stores distinguish 71 dif-

[10] *Standard Expense Center Accounting Manual* (New York: National Retail Dry Goods Association, 1954).

ferent "expense centers" which correspond roughly to minor organizational departments. In smaller stores, certain of these 71 centers are consolidated into a more appropriate number of organizational divisions. Whereas a department store formerly knew only that its accounts receivable and credit office expense amounted to some very small per cent of sales, it now knows, in an illustrative example, that "accounts receivable and credit centers processed 16 credit transactions per manhour at a payroll cost of 7.8¢ per transaction."[11] When business managers can operate with the benefit of such data, they know specifically the results achieved for the cost incurred. By comparing their own experience with typical or ideal cost standards, it is apparent that they have not only a useful tool for measuring productivity but also a control device for enhancing it.

Value Added Approach to Productivity. The approach to the measurement of productivity which appears to offer greatest promise for future application is one in which value added by marketing is used as a measure of marketing output. As previously indicated, value added does not itself measure productivity. It merely measures production, the creation of economic values within the marketing sector of the economy or within any enterprise in this sector.

Usually, in measuring productivity, an attempt is made to relate output to one or more of several factors of production deemed principally or partly responsible for it. This has most commonly resulted in measuring productivity in terms of output per unit of direct labor, such as a manhour. It is obvious that when this is done, the value added more nearly represents the real contribution made by a unit of labor than do dollar volume of sales, physical volume of goods handled, units of functional service, or other available measures. Considerable research effort is being devoted to the problems of measuring accurately value added by marketing within firms, by industries or lines of trade, and for all marketing institutions. It is believed therefore that business managers will be able to apply this concept practically for purposes of internal business operation, just as this is currently being done in a social or industry-wide sense by scholars, researchers, and business leaders who are interested in the problem.

In concluding this discussion, it is appropriate to point out the common fallacy in many productivity studies—namely that of using *solely* manhours of direct or operative level labor as the denominator in the equation used in making computations of productivity. This practice has led many to believe that all increases in productivity are attributable to such labor. The truth of the matter is that supervisory or indirect labor may have had as much or more to do with enhancing productivity as direct labor. For

[11] Typical experience as reported in Malcolm P. McNair, *Operating Results of Department and Specialty Stores in 1954,* op. cit., p. 42.

example, employees within the research department of a large department store devised a new method of recording and processing a certain type of charge transaction. As a result, salespeople in certain departments could handle twice the number of this type of transactions per hour in peak periods.

Increased productivity may frequently be caused far more by greater capital investment per unit of product or per employee than by increased skill or application of labor. For this reason, productivity may well take the form of a ratio of value added (output) to investment in equipment or to the hours of operation of such equipment, resulting in a capital productivity ratio.

Also, management may be chiefly responsible for enhanced productivity. A case in point is the redesigning and rearrangement of the entire order filling procedure in a wholesale warehouse, with the result that four men could fill more orders per day after the rearrangement than seven could according to the previous method. While there was an obvious increase in output per worker, the type and skill of labor used in the warehouse remained the same. Labor cannot, therefore, in this instance be considered as *the source of* the increased productivity.

Finally, land as a factor of production may be the principal explanation for an increase in productivity in a given situation. It is well known that the specific site occupied by a retail store, and sometimes by a wholesale establishment or other business, has much to do with the total amount of business done and value created by it.

It is readily apparent from the discussion in this chapter that much is yet to be learned about value added, costs, efficiency, and productivity in marketing. Much educational work is to be done in the business community and in institutions of learning if sound economic concepts are to be developed and widely applied. The amount of work to be done by researchers and analysts in applying these concepts to problems of business management constitutes one of the greatest challenges and opportunities in contemporary marketing.

QUESTIONS AND PROBLEMS

1. Define or briefly explain the meaning of the following terms:
   a) explicit costs
   b) implicit costs
   c) social costs
   d) value
   e) value added
   f) production
   g) utility
   h) gross margin
   i) productivity
2. How does the concept of "value added" by marketing differ from the concept of marketing "cost" (a) from the standpoint of an individual marketing institution and (b) from the standpoint of the economy as a whole?

3. What are the major reasons for giving attention to the concept of value added by marketing? Explain.
4. Explain and evaluate the various bases for measuring the costs of marketing.
5. During the present century, has the cost of marketing increased, declined, or remained the same? Absolutely or relatively? If the cost has increased in any way, does it mean that marketing is less efficient today than in the past?
6. A retail grocer criticized the high costs of doing business of a furniture store which, because of such high costs, insisted on a markup of about 40 per cent of the selling price on its merchandise. The grocer who wanted to buy some of the furniture objected and pointed out that he is operating on only a 20 per cent margin. What do you think of the grocer's contention?
7. Assume that you have been asked to ascertain the costs of marketing fresh California oranges. What would be the quickest and most economical method of doing this?
8. In recent years, several marketing experts have estimated the costs of marketing goods in the United States. These estimates have varied considerably. How do you account for this wide variation?
9. Unit manufacturing costs have been declining over a number of years, while unit costs of marketing have been on the increase. What is the explanation?
10. Product X costs its manufacturer 75 cents to produce and 20 cents to sell. He sells it to wholesalers for $1.05. Wholesalers take a 12 per cent markup (based on cost), and retailers add a 32 per cent markup (based on selling price). It costs 3 cents per unit to ship this product to the wholesaler, and 4 cents to ship it from wholesaler to retailer. Shipments are made on an f.o.b. basis in both cases. Select pertinent information from the above and determine the actual cost of marketing this product.
11. How do you explain the wide variations in the operating costs of:
    a) Wholesalers *and* retailers in the same line of business?
    b) Wholesalers *or* retailers in different lines of trade?
    c) Retailers in the same line of business?
12. Our wholesaling and retailing systems have been characterized as inefficient. A moderate sum of money has been made available by some trade associations in those fields for the purpose of making a study that throws light on this point. As a director of such a study, what factors would you wish to have covered by this study and why?
13. At a convention a certain speaker stated that it should be our aim to make the marketing system in the United States the most efficient in the world. Just what did the speaker probably have in mind, and do you agree that that should be our aim?
14. In what specific ways is the marketing system less efficient than the system of factory production? Is this condition inherent in the marketing task or should an effort be made to place marketing on a par with factory production?

15. Two drugstores in a given community have operating costs of 30 per cent and 24 per cent of sales, respectively. Which is the more efficient?

16. What are the main approaches to the question of determining productivity in marketing? Evaluate each one with respect to application from the point of view of (a) internal management within a particular firm and (b) measuring productivity for the whole field of marketing.

17. Company X manufactures automobile batteries. Different channels of distribution are used for different types of customers. To the large automobile manufacturers and the large retail chains of automotive parts, sales are made direct. Some of the largest independent retailers and repair stations also buy direct from the factory; but the host of small dealers buy from wholesale distributors. What problems would arise in attempting to figure the total costs of distribution by the following methods?
    a) Consumer prices less production costs
    b) Gross margins of marketing agencies
    c) Individual functional costs

18. The retailer was accused of receiving too high a profit on his goods. The critic said that the markup was 40 per cent on the dollar, figured from the cost price of the goods. Moreover, said the critic, with the 20 per cent markup taken by the manufacturer the marketing costs on the goods were more than the cost to produce them. The manufacturer's markup was found by comparing his production costs to selling price. How may the retailer refute the argument of the critic? What fundamentals must be remembered in figuring marketing costs in this way?

19. A manufacturer of a new insecticide product is considering the problem of selecting channels of distribution. He feels that he needs some good information on the cost of marketing through various alternative channels. What method would you employ in a study that might supply the needed facts? Explain.

20. John McGowan is the proprietor of an independent self-service grocery store. He is a progressive merchant and keeps and takes great pride in maintaining accurate accounting records. His books are periodically audited by a public accounting firm as a double check on their accuracy. At the end of the year, the profit and loss statement reveals sales of $300,000, merchandise costs of $246,000, operating expenses of $42,000, and a net profit of $12,000. An economist, when informed of this situation, states that the amount of $42,000 is undoubtedly an understatement of the cost of operating this business. How can you account for his position in view of the careful manner in which the accounting records are maintained?

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MARKETING AND THE GOVERNMENT

Throughout this volume reference has been made to various acts of the state and federal governments, of a legislative or administrative nature. Heretofore these have been considered in relation to their effect upon particular marketing institutions, functions, or policies. In this concluding chapter, the role of government is approached from a more direct and possibly over-all point of view, with attention given to its influence generally upon the domestic marketing activities of competitive business enterprises. To a large extent, the discussion is concerned with the philosophical basis that underlies the role of government in this field, as illustrated by certain major laws and agencies of enforcement which are of continuing current significance. Excluded from the treatment are laws having to do primarily with the control of agricultural production and prices; these are of a special character and separate attention has been given to their *raison d'être* in Chapter 18.

BACKGROUND FOR MARKETING LEGISLATION

All the important legislation dealing with the current regulation of marketing has been enacted within the lifespan of individuals presently active in the field. To facilitate the understanding of the rather rapid development of a network of such legislation, it is essential to consider some aspects of the historical background.

Rise of Laissez Faire. In its true sense, a laissez-faire policy is one in which there is complete absence of governmental activity relating to business (of which marketing is an important part), whether such activity be helpful or restrictive. In this sense it is believed that such a policy never

has really existed. In the more moderate view, as expressed by the father of classical economics, Adam Smith, in his *Wealth of Nations,* published in 1776, it would imply absence of governmental intervention in business except to protect society and each member thereof from violence, injustice, or oppression. It would further leave for the government the erection and maintenance of certain public works and institutions which private persons could not operate profitably but which are socially desirable. The essence of such a view of laissez faire is expressed in the following words of Adam Smith: "Every man, as long as he does not violate the law of justice, is left perfectly free to pursue his own interest in his own way, and to bring both his industry and capital into competition with those of any other man, or order of men,"[1] the assumption being that, in the long run, what is good and profitable for the individual entrepreneur is likely also to be good and profitable for society at large.

Even in the more moderate sense, it is extremely doubtful whether a complete laissez-faire policy actually ever existed. Certainly there has been much regulation of business during the mercantilistic era and no little of it existed before that time. All one needs to do is to refer to the English statutes as early as 1552 which made criminal offenses such practices as the following: (a) *forestalling,* which was a practice of buying up goods on the way to market in order to corner the supply and thus secure higher prices; (b) *engrossing,* i.e., the buying up of large quantities of goods at a given time or in a given market and holding them off the market so that they could be resold later at exorbitant prices; and (c) *regrating,* which involved resorting to such methods as conspiracy and the spreading of false reports for the purpose of increasing the price of food. There were also laws against selling by sample, and there were regulations governing the time and place of sale of certain commodities. Moreover, these laws were but crystallizations of views previously held under common law and fairly generally enforced.[2]

In the very times when the laissez-faire doctrine was preached and on the very soil on which it was nurtured, numerous encroachments upon the policy are to be found. Witness, for example, the restraints, either by high tariffs or by direct prohibition, placed upon the importation of goods from countries with which the balance of trade was supposed to be unfavorable, the bounties given by the government, the monopolies allowed by special charter, and other governmental activity designed to facilitate commerce in general and certain branches of trade in particular. But during the modern period in history England adopted a free policy, price regulations were

[1] *Wealth of Nations,* Book IV, chap. ix.

[2] As early as 794, a year of "hard times," Charlemagne, in a capitulary passed by the Church Council, prohibited profiteering in wheat and other foodstuffs, fixed maximum prices on these commodities, and apparently forbade forestalling (*Monumenta Germaniae Historica,* Legum II, I, 74).

minimized, and certain other regulations impinging upon business were relaxed or eliminated. Thus there was relatively less government interference with business than in preceding eras, hence the application of laissez faire.

Decline of Laissez Faire. In the United States rugged individualism and free-for-all competition characterized the business structure until late in the nineteenth century. With but few exceptions, this country has followed in the footsteps of the mother nation. As long as the frontier remained and the conquest of the West afforded many opportunities for the profitable employment of labor and capital, there was little demand for government interference with business. Furthermore, there was fairly keen price competition, an essential prerequisite to a laissez-faire policy. Small-scale operation was the rule. It was relatively easy for a producer or merchant to enter a new field of activity. Inefficient institutions fell rapidly by the wayside. Rates of wages and interest were relatively flexible; and there were few understandings, combinations, or restrictions against newcomers or with respect to prices. While competition was far from perfect, it was nevertheless real and substantial.

These conditions have changed radically during the second half of the nineteenth century. Under the impetus of the Industrial Revolution, business units expanded rapidly, industry became more largely mechanized, large-scale production in certain fields almost displaced the smaller plants, and the corporate form of organization gave aggressive business leaders the means for gathering large sums with which to utilize the advantages of large-scale operation. Through pools, trusts, and combinations control was obtained by a limited number of captains of industry over enormous blocks of capital. The newly arisen business giants waged an unequal warfare against the smaller enterprises. Restrictions against the free play of competitive forces multiplied until they became legion, affecting both the price paid for goods by business firms and the price charged for them when their products were offered for sale. Instead of price competition, we entered upon an era of relative price rigidity, uniformity, and control by business groups. Under such conditions it was no longer possible to rely upon laissez faire and the assumed economic automatism resulting from a free play of supply and demand factors. Competition failing to regulate itself satisfactorily, business and the public turned to the government for assistance with a plea for restoration of the competitive order as it had functioned before.

Competition Under the Common Law. Before any specific legislative enactments are studied, it is well to consider the manner in which competition, or the lack of it, was regarded under the common law. Before the passage of any trade legislation by the federal Congress or the several states, it may be said that competition was favored by the common law of this

country, which was patterned after the common law of England. Contracts which were in restraint of trade had been held void as being against public policy and could not be enforced. Other practices tending in that direction were similarly held unenforceable. Among the latter practices were included agreements to fix prices, to control the market, or to abstain from engaging in the same kind of business for an unreasonable time after selling out to a competitor. Trust agreements and holding company devices were similarly regarded. Many of the court decisions under the common law clearly indicated an intent to prevent such practices and to preserve competition. But the common law and the decisions under it proved inadequate, because action was taken only upon complaint of an injured competitor and in behalf of such a party. They thus failed to protect the interests of the *public.*

Legislation Affecting Marketing

As early as 1816, the United States government began to depart from the laissez-faire policy when it adopted the first protective tariff. But it was not until long after the Civil War that government intervention in business assumed some significance. Control over our banking system was increased; at first the states attempted to regulate the railways, and in 1887 the federal government stepped into this field with the Interstate Commerce Act. However, the real beginning of a series of measures generally considered as trade legislation was the Sherman Antitrust Act, passed in 1890.

Competitive Implications of Marketing Legislation. Before considering the Sherman Act and others which have followed it, a question may be raised about the possibilities of classifying and evaluating such laws in terms of social objectives. If it may be assumed that public policy should be guided by a concept of the desirability of a system of fair and workable competition, then this concept may serve as a basis for evaluation. Practically all the legislation that affects marketing can, it is believed, be classified into four categories with respect to workable competition.

First, certain laws have very little to do with competition in any direct manner. Illustrative is the Fair Labor Standards Act which protects the worker by placing a floor on wages and a ceiling on hours. It has influenced competition only indirectly and to the degree that it has changed the operating cost structure of certain firms. Another example is the Food, Drug, and Cosmetic Act, enacted to protect the health and welfare of the public. Still other illustrations are provided by a wide range of promotive measures that have been directly beneficial to business, including those having to do with the establishment of weights and measures, the formation of corporations, the provision of standard bills of lading or warehouse

receipts, and so on. Laws in this general class are outside the scope of the following discussion.

The other three classifications consist of laws which have the purpose or effect of (1) preserving competition, (2) promoting competition, or (3) restricting competition. Certain laws may have the effect of preserving competition in that they tend to maintain the status quo; i.e., they tend to cast the existing state of competition into a mold and keep it there. Others may promote competition by making it more workable, more vigorous, or more effective. Still others may restrict it by inhibiting the economic freedom of rivals in their struggle for customer patronage.

Whether a particular law should be placed in one or another of these classes is often difficult to determine and may depend upon whether one takes a short-run or long-run point of view. A law which appears to restrict competition, when consideration is limited to its immediate or short-run effects, may actually have the long-run tendency to encourage and promote a healthier state of competition; and it is the long-run intent or effect that is of real import from a social viewpoint.

Although the above classifications are neither precise nor definitive, it is believed that they may serve as one basis for evaluating governmental activity in the field of marketing. By keeping them in mind as attention is given to individual acts, the student should be better prepared to make mature and considered judgments.

The Sherman Act. The Sherman Antitrust Act, passed in 1890, was intended to remedy some of the defects in the common law which made enforcement of competition difficult. It was further stimulated by a wave of mergers, consolidations, combinations, and agreements to control prices, markets, and production, which swept the country after the Civil War. Even before the enactment of this law several state legislatures passed similar legislation which, however, failed to cover interstate commerce.

The Sherman Act restricts by statute certain noncompetitive practices. It forbids: (1) contracts, combinations, or conspiracies in restraint of trade, and (2) actual monopolies or attempts to monopolize any part of trade or commerce. Responsibility for enforcement of these provisions rests with the Department of Justice.

This law was intended as a curb upon attempts of large organizations to stifle the small. It has been argued that bigness often results in monopolies, duopolies, or oligopolies, and that these in turn introduce into the economic system price rigidity, stagnant production in periods of depression, and consequent unemployment. In more recent years, added concern has been felt on this score because, as alleged by some critics, big business tends to convert this country into a nation of employees dependent upon the will of absentee owners and because it closes the field of industry and trade to

new and small enterprises.[3] Friends of bigness claim, however, that price rigidity has always characterized certain manufactured goods, especially those of the durable type, because the demand for many of them is relatively inelastic in periods of depression and depends upon the demand for more or less perishable consumer goods. They also call attention to the social good which has resulted from increased output and improved quality made possible by large-scale operations.

Early court decisions under the Sherman Act almost nullified the purpose of the law. This was especially true in the Knight case, which was an unsuccessful attempt to break up the sugar trust, when the Supreme Court declared that manufacturing was not commerce (even though the products of the factory are sold in interstate commerce) and was therefore not subject to the provisions of the federal law.[4] This decision gave further impetus to consolidations, and it was not until 1904 that the Supreme Court completely reversed its line of reasoning when it declared a holding company formed for the purpose of controlling certain business enterprises to be in violation of the law.[5] Later victories for the government against the oil and tobacco trusts strengthened the belief that monopolies might be prevented in this country and ushered in an era of trust-busting, although here the so-called rule of reason was introduced when the Court declared that only when contracts and combinations restrain trade *unreasonably* are they to be regarded as in violation of the law.[6] The injection of the *rule of reason dictum* caused much confusion and introduced controversies that have not as yet been completely resolved.

The Clayton Act. It was on account of the confusion caused by Supreme Court decisions under the Sherman Act, the delays incident to normal court procedures, and because of inadequacies in the older law that Congress was moved to provide more specific legislation in 1914. Thus within a period of a few weeks were passed the Federal Trade Commission Act and the Clayton Act, both designed to place some curbs upon big business and to prevent unfair and monopolistic trade practices.

Of the two, the Clayton Act was more directly a substitute for and a supplement to the Sherman Act. In order to escape difficulties associated with enforcing the vague nature of the prohibitions in the older law, certain more definitely phrased violations were spelled out.

The various practices specified in the Act are not prohibited in a blanket manner, but are generally subject to the qualification, "where the effect

[3] C. G. Daughters, *Wells of Discontent* (New York: Newsom & Co., 1937), chaps. xi and xiv.

[4] *U.S. v. E. C. Knight*, 156 U.S. 1 (1895).

[5] *Northern Securities v. U.S.*, 193 U.S. 197 (1904).

[6] *Standard Oil Co. v. U.S.*, 221 U.S. 1 (1911); *U.S. v. American Tobacco Co.*, 221 U.S. 106 (1911).

will be substantially to lessen competition or tend to create a monopoly." Thus, while something definite was gained over the Sherman Act by phrasing specific prohibitions in clear language, something of the vague and indefinable character of the former law remained in the qualifying clause. The legality or illegality of the practices became dependent upon whatever interpretation the courts chose to give to this qualification.

One of the important prohibited practices was discrimination in price between purchasers of a like grade, quality, or quantity of the commodity sold. This provision was later amended by the Robinson-Patman Act and is considered in some detail in a section of this chapter dealing with that law.

Second, the act declared it unlawful to lease or sell goods on the condition or agreement that the lessee or purchaser shall not use or deal in goods provided by a competitor of the lessor or seller. This provision imposed restrictions upon exclusive-dealing arrangements and upon so-called "tying contracts" which obligate the buyer or lessor to purchase supplementary and, perhaps, undesirable lines of merchandise in order to obtain desired items. This may be illustrated with reference to a case that involved a soft drink bottling company. A distributor was granted the exclusive right to bottle and market a cola product under the trademark name of a secret formula concentrate, but under the condition that the distributor was not to bottle or market any nonalcoholic beverages other than those bearing the cola company's name and, further, that the distributor purchase from the cola company a specified minimum annual quantity of other common flavor concentrates which were available on the open market from a variety of sources. These provisions were held to be in violation of the Clayton Act.[7]

Third, the law prohibited interlocking directorates in directly competing corporations (except banks and common carriers) of more than $1,000,000 capital. An important case involved a common directorship in Sears, Roebuck & Company and The B. F. Goodrich Company. It was admitted by the defendants that they competed in 97 communities in 31 states through 110 retail stores of Sears and 112 retail stores of Goodrich, all of which sold major household appliances, hardware, automotive supplies, sporting goods, tires and tubes, radios and television sets, and toys. The court found that a common directorship was illegal "since a price fixing or division of territory agreement would eliminate competition between them."[8]

Fourth, the act made it unlawful for a corporation engaged in commerce to acquire the stock of another corporation, and (by amendment in 1950)

[7] *Red Rock Bottlers, Inc., v. Red Rock Cola Co.*, U.S. District Court for the Northern District of Georgia, Atlanta Division, Civil Action 3892 (1952).

[8] *United States v. Sears, Roebuck & Company, The B. F. Goodrich Company, and Sidney J. Weinberg*, In the U.S. District Court for the Southern District of New York, Civil Action 73–293 (1953).

for a corporation subject to the jurisdiction of the Federal Trade Commission to acquire the assets of another corporation, subject to the qualification, previously noted, where the effect may be substantially to lessen competition. The nature of this provision was illustrated in Chapter 30, in the case of the acquisition by Pillsbury Mills of the assets of two of its competitors.

Authority to enforce this law, insofar as production and marketing aspects are concerned, was vested principally in the Federal Trade Commission which was created almost simultaneously. The authority of the Commission was, of course, made subject to appeal to the federal courts, since the status of the Commission is in a sense on the same level as that of federal district courts.

Certain special interest groups were exempted from the provisions of the Clayton Act and from the antitrust laws in general. It was provided that nothing in the Clayton Act "shall be construed to forbid the existence and operation of labor, agricultural, or horticultural organizations" not having capital stock or conducted for profits, and that members thereof could not be construed as being in illegal combinations or in restraint of trade as long as they were pursuing the legitimate objectives of such organizations. Exemption of the activities of bona fide agricultural marketing cooperatives was made more specific and was somewhat broadened a few years later by the Capper-Volstead Act (1922). This law provided that persons engaged in the production of agricultural products may act together in associations, *with or without* capital stock, for collective marketing and further that such associations may have marketing associations in common. Under this law, marketing cooperatives may enter into agreements that bind their members to exclusive dealing, and they may make agreements that are tantamount to price-fixing so long as the Secretary of Agriculture has no reason to believe that prices are driven to an unduly high level.

The Federal Trade Commission. This law enforcement agency was brought into being by the Federal Trade Commission Act of 1914 and, as stated above, for the same reasons that led to the passage of the Clayton Act. The substance of the legislation lies (a) in the prohibition of *unfair methods of competition* in commerce, as well as unfair or deceptive acts or practices in commerce, and (b) in the provision of a method, machinery, and a body of experts to handle the cases falling under its jurisdiction. Fortunately, the law does not specify or condemn particular practices. Instead, it empowers the Commission and the courts to look into each practice or device in question and determine its effect upon trade before it is declared unlawful. From 1914 until 1938, the authority of the Commission was restricted to cases in which there was *injury to competition;* business practices which might be construed as unfair from a public or social

viewpoint were not covered, so long as they were a common practice among all or most competitors in a given line of trade.

Broadening of the Commission's Powers by the Wheeler-Lea Act. Control of unfair methods of competition by the Federal Trade Commission was made more comprehensive by the passage of the Wheeler-Lea Amendment to the Federal Trade Commission Act in 1938. This law made three important changes. It broadened the Commission's jurisdiction to include practices that injure the public but which may not involve or injure a competitor. Prior to this amendment, action could be brought only upon complaint of a competitor who was presumably injured by an allegedly unfair practice. Now the Commission may take action of its own accord if *public* injury can be shown.

If not appealed to, the Commission's orders to cease and desist now become effective after 60 days. Moreover, it shortens the process of enforcement by providing for suits in the district courts where substantial penalties may be inflicted, a $5,000 civil penalty being provided for each violation of a cease and desist order after it became final.

But the most important of the three principal changes made by the Wheeler-Lea Act is that which pertains to the advertising of foods and drugs. It definitely prohibits false advertising of food, drugs, cosmetics, and therapeutic devices.

Other Acts Administered by the Commission. In addition to the Federal Trade Commission Act, the Clayton Act, and the Wheeler-Lea Act, several other federal laws fall specifically within the province of the Commission. Most important of these is the Robinson-Patman Act which is discussed in detail below. Another is the Webb-Pomerene Act of 1918, which was passed for the purpose of exempting from the Sherman Act any agreements or associations made solely for the purpose of engaging in export trade. Associations formed in accordance with the provisions of this Act must file papers with the Commission; and the Commission, in turn, is charged with the responsibility of seeing that papers are on file and that the operations of such associations are in accordance with the law.

Still another law is the Wool Products Labeling Act (1939) which provides that products containing wool must bear a label disclosing the kind and percentage of each fiber, including the relative percentages of "wool," "reprocessed wool," and "reused wool." The Commission maintains a staff of inspectors to check on compliance, and enforcement proceeds by means of conferences and the use of cease and desist orders.

The Commission is similarly charged with the enforcement of the Fur Products Labeling Act (1951) which prohibits the false advertising or misbranding of fur products and which requires that such products be plainly labeled with the true English name of the animal bearing the fur and the

actual country of origin, if imported. It also enforces the Flammable Fabrics Act (1953) which prohibits the introduction or movement in interstate commerce of articles of wearing apparel or fabrics which are so highly flammable as to be dangerous to individuals.

Under the Lanham Trademark Act (1946), it is provided that the Commission may institute proceedings for a cancellation of registered trademarks which are deceptive, immoral, or scandalous; which have been obtained fraudulently; or which are in violation of other provisions of the Act.

Even though the Sherman Act is the specific responsibility of the Department of Justice, the Federal Trade Commission may be very properly regarded as an antitrust enforcement agency, because in numerous cases it has been ruled that any violation of this Act may properly be construed as an unfair method of competition or may be injurious to the public interest and hence fall within the province of the original Federal Trade Commission Act or the Wheeler-Lea Amendment. Furthermore, it is charged with the enforcement of the Clayton Act, which is definitely antitrust legislation.

Present Scope of Control over Unfair Competitive Practices. Through liberal judicial interpretation of the law that originally brought the Federal Trade Commission into being and through subsequent legislative enactments as just discussed, the list of unfair methods of competition has been continually expanding. At the present time, the Commission has jurisdiction over all methods that are *unfair as against good morals* if used in interstate commerce and the action is in the public interest. These are characterized by fraud and deception and must result in injury to competitors or the public. A case in point is misrepresentation of one's own goods as to origin, quantity, quality, effectiveness, advantage, or price. The same applies to misrepresentation of one's business as to identity, character, and status. Other unfair practices falling in this category are deceptive interference with competitors, disparagement of a competitor's goods or business, commercial bribery, deceptive selling schemes, lottery, and other immoral methods such as style piracy.

A second class of unfair methods that come under the jurisdiction of the Federal Trade Commission are those that are *trade restraining or of a monopolistic nature.* These, too, must be employed in interstate commerce and proceedings must appear to be in the interest of the public. Among these may be listed cooperation and combination through: contracts and conspiracies in restraint of trade, illegal agreements and codes, trust agreements, holding companies, illegal mergers, and interlocking directorates. Similarly treated are coercion and restraint through: tying contracts, full-line forcing, exclusive dealing, price discrimination, resale price maintenance (except as permitted under Fair Trade laws), and imposition of ar-

bitrary terms, conditions, and rates. Finally the Commission exercises power over *destructive competitive practices* such as selling below cost, boycotts, harassing devices like interference with a competitor's supply of goods, or other hindrances to his sales and operations.

Thus, while the power of the Commission is now vast and has been greatly expanded in more recent years, its original purpose was not unlike that of the Sherman Act, namely, to *preserve competition through the prevention of monopolies and restraints upon trade and to insure a certain degree of honesty in business as contemplated under the common law*. It differed only in scope and flexibility, and in the provision of a method and machinery for enforcement.

Trade Practice Rules. An important aspect of the work of the Federal Trade Commission consists of the assistance it gives to specific industry groups that are interested in voluntary and cooperative effort to eliminate unfair methods of competition through what are known as "trade practice rules." Such rules have been promulgated for about 300 different manufacturing, wholesale, retail, and service trade or industry groups.

Requests for trade practice rules have often originated in industries that are currently plagued with a variety of unethical or presumably unfair marketing practices, particularly when such practices have become so general that they have some effect upon a large proportion of the industry membership. Interested individuals who desire to raise the level of ethical standards and eliminate unfair practices may approach the Trade Practice Conference Division of the FTC with a plea for a conference. At a preliminary meeting, a representative industry committee is formed to work with the Commission. After a number of meetings and conferences, preliminary drafts of rules are submitted to the Commission. When these meet with the Commission's approval, they are given public hearings so that they may come to the attention of all members of the industry. Thus, each person affected by them is given an opportunity to voice objections or suggest revisions. After final revision, rules are officially promulgated by the Commission.

The general purposes of such rules may be summarized as follows: to interpret the important provisions of existing laws as they apply to a particular industry; to bring together in one convenient publication a codification of the provisions of a variety of laws affecting the industry; to clarify the laws by giving them concreteness and meaning through appropriate examples as to what is an unfair method of competition or a deceptive practice within the particular industry; to provide industry members with substantial guidance as to the lawfulness of certain of their activities; to give an opportunity for an industry to "clean house" through self-discipline;

and to remove the pressure to engage in questionable practices to meet equally questionable practices of competitors.

In order to accomplish these objectives two groups of rules are ordinarily formulated. Group I rules consist of those which are considered to be unfair methods of competition, unfair or deceptive acts or practices, or other illegal activities, which are prohibited by laws administered by the Federal Trade Commission. In statements prefatory to these rules it is generally stated that "appropriate proceedings in the public interest will be taken by the Commission to prevent the use, by any person, partnership, corporation, or other organization subject to its jurisdiction, of such unlawful acts in commerce."

Group II rules deal with practices which are believed to be conducive to sound business methods, when it is desired to encourage and promote them through publicity and voluntary cooperation. If such rules are not observed by an industry member, he does not necessarily violate the law. The Commission will take no steps to enforce Group II rules unless the violation assumes such a character that it actually becomes an unfair method of competition.

While unfair or deceptive acts in commerce are illegal under the Federal Trade Commission Act, even in the absence of trade practice rules, businessmen within a trade are likely to be confused by the legal terminology of statutes, and are likely to place a wide variety of interpretations upon what is or what is not unfair or deceptive. The manner in which certain of the aforementioned objectives of trade practice rules may be attained by a clear statement in specific trade terminology is illustrated by one of the 21 Group I rules which have been promulgated for the nursery trade. This is as follows:

RULE 5—DECEPTION AS TO BLOOMING, FRUITING, OR GROWING ABILITY.

In the sale, offering for sale, or distribution of industry products, it is an unfair trade practice for any industry member to deceive purchasers or prospective purchasers as to the ability of such products—

(a) to bloom, flower, or fruit within a specified period of time; or

(b) to produce crops within a specified period of time, or to give multiple crops each year, or to produce crops in unfavorable climatic regions; or

(c) to bear fruit through self-pollinization; or

(d) to grow, flourish, and survive irrespective of the climatic conditions, the care exercised in or after planting, or the soil characteristics of the locality in which they are to be planted.

(*Note:* Under this rule, when flower bulbs are of such immaturity as not reasonably to be expected to bloom and flower the first season of their planting, such fact shall be clearly and conspicuously disclosed in all advertisements and sales promotional literature relating to such products; *provided, however,* that such disclosure need not be made when sales are confined to nurseries and commercial growers for their use as planting stock.)

It is also an unfair trade practice to sell, offer for sale, or distribute industry products which have been used in the commercial greenhouse production of cut flowers (e.g., greenhouse bench or bed-grown rose bushes) without adequately and nondeceptively disclosing that such products were used in the commercial greenhouse production of cut flowers and discarded after having served their usefulness in such production.[9]

In some trades, interest in the rules has waned after promulgation; in others, active industry committees have continued to work with the Federal Trade Commission, bringing violations of the Group I rules to the attention of that body for proper legal action. Even when enforcement has been lax, much of psychological, educational, and exemplary value has been accomplished in the process of formulating the rules and getting them promulgated. Psychological benefits stem from the fact that certain firms are fearful of violating the law and will tend to conform, in the belief that action may be taken against them if they do not. Much is written about the rules in trade magazines and other sources so that industry members receive some education in trade law. Finally, leaders of the industry have an opportunity to speak out for the rules in meetings, to abide by them in a conspicuous manner, and thus encourage better business practices through precept and example.

The Robinson-Patman Act. With the passage of the Robinson-Patman Act in 1936 federal regulation of marketing transactions was greatly expanded. The Sherman Act of 1890 was designed to curb or prevent certain monopolistic practices primarily among manufacturers, for it was in that area of business that allegedly unfair competition was believed to be most common; and it certainly was in that area that consolidations, mergers, and combinations with a restraining effect on trade took place. But with the growth and development of mass distributors, especially chain store systems, there came a realization on the part of many of their smaller competitors, students of marketing, and some legislators that certain practices had grown up which gave the large buyers of the mass-distributor type lower prices than they were entitled to receive on purely economic grounds, i.e., on the basis of the relative cost of selling to them on the one hand and to the smaller distributors on the other. It was further known that, in some cases at least, sellers were allowing so-called brokerage fees which were in effect additional discounts from basic price quotations, as no brokerage service was rendered to the seller. Other practices, including the rendering of free services, allowances for advertising that were not used for such purpose or were out of proportion to such actual expenditure, the use of "hidden demonstrators," and many other special devices, were alleged to make competition among distributors still more inequitable. Consequently, after long

[9] *Trade Practice Rules for the Nursery Trade* (Washington, D.C.: Federal Trade Commission, 1956), p. 6.

consideration of much testimony that was presented to its committees the 74th Congress passed the Robinson-Patman Act principally as an amendment to the Clayton Act of 1914.

Major Provisions of the Act. The chief purposes of the Robinson-Patman Act, as stated in the preamble of the Bill when it was introduced, were:

1. To make it unlawful for any person engaged in interstate commerce to discriminate in price or terms of sale between purchasers of commodities of like grade and quantity
2. To prohibit the payment of brokerage fees or commissions under certain conditions
3. To suppress pseudo-advertising allowances
4. To protect the independent merchant, the public whom he serves, and the manufacturer from whom he buys, from exploitation by unfair competitors

The purposes outlined above are to be accomplished mainly through three provisions contained in Section 1 of the Act which amends Section 2 of the Clayton Antitrust Act. Enforcement of these provisions, which are discussed in detail in the paragraphs that follow, is in the hands of the Federal Trade Commission.

Prohibition of Price Discriminations. Probably the most important provision of the Robinson-Patman Act is that which *prohibits discriminations in price between different purchasers of commodities of like grade and quality, where any of the purchases involved are in interstate commerce, and where the effect may be substantially to lessen competition or to tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them.* This does not mean, however, that price discriminations in the sense of price differentials are entirely prohibited, or that a seller is compelled or required to grant any price differentials whatever. Any vendor may sell to all his customers at the same price regardless of differences in the cost of serving them. But if different prices are charged to different customers, the discriminations or differentials must not exceed the "differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."

Thus, whatever price differentials are granted must not exceed the savings effected by the seller in serving the customer receiving them, but they need not be the exact arithmetical equivalent of the savings. Moreover, the law places the burden of proof on both buyer and seller and requires a definite justification for the discounts granted and received. Other defenses under the law have also been set up in connection with this provision. For

example, selection of customers is permitted where it is done in good faith and not in restraint of trade. Price changes are permitted to meet market fluctuations, to dispose of perishables, or to avoid obsolescence of seasonal goods. Distress sales under court order are similarly allowed, as well as bona fide closing-out sales. More important, however, are the escapes provided by the necessity in good faith to meet the lower price of a competitor or the proof that the discrimination had no adverse competitive effect upon other sellers, as between different buyers, or as between the customers of the different buyers.

The manner in which the Robinson-Patman Act limits the pricing freedom of sellers has already been illustrated with a number of cases cited in Chapters 33 and 34, especially in connection with discussions of varying price policies, functional discounts, cumulative and noncumulative quantity discounts, delivered pricing practices, and absorption of freight.

It is of special interest to note that in enforcing this law, the Federal Trade Commission does not have the burden of establishing that competition *was actually* damaged by a practice which is the subject of a complaint. The phrase, "where the effect *may be* substantially to lessen competition," has been interpreted judicially to mean that the statute was meant to curb discriminations in their incipiency, before any actual harm was done. In a case involving this point, the Commission had found that different customers of a supplier paid different prices for glucose. It also found that differences of a small fraction of a cent in the sales price of candy (whose principal ingredient was glucose) was sufficient to divert business from one candy manufacturer to another. It was ruled that the law did not require an actual adverse effect upon competition, that the Commission's findings supported the inference of a *reasonable probability* that the effect *could have been* to substantially lessen competition.[10]

This does not mean that all differences in prices paid by buyers are likely to come within the scope of the reasonable probability concept. In a case involving sales at alleged discriminatory prices by the Minneapolis-Honeywell Regulator Co., facts were presented to show that competitors' prices were lower than the prices of the company; that price competition was keen in the industry; that business of competitors was increasing; that new concerns had entered the field and were prospering. The court ruled that unless the discriminatory prices charged by a manufacturer did or might have tended to injure competition or prevent competition between the company and its competitors, there was no need for the manufacturer to justify the discriminations. Under conditions where it was shown that new competition had been able to come into the industry and thrive in spite of the alleged

[10] *Corn Products Refining Co. et al. v. Federal Trade Commission* (U.S. Sup. Ct., 1945), 324 U.S. 726.

discriminatory prices, it could not be said, according to the ruling, that the effect of those practices was substantially to injure competition.[11]

From the foregoing, it appears that it is difficult to determine whether or not a given differential in price among customers may have consequences of a magnitude sufficient to constitute a prima-facie case under the Robinson-Patman Act. It is evident from recent court decisions, however, that the effect must be "substantial, not trivial or sporadic, interference with competition to establish violation."[12] Counsel for the Commission has the burden of establishing proof of the necessary degree of injury to competition; this presupposes that a realistic inquiry will have been made into the business context and market effects of a challenged discrimination before a Federal Trade Commission complaint will be issued.[13]

Considerable interest has also focused upon the responsibilities of a buyer under the Robinson-Patman Act, with respect to the phrase, "who either grants or knowingly receives the benefit of such discrimination." This has raised many questions about the freedom of a buyer to negotiate favorable purchase prices. Under what conditions, for example, is a purchaser liable to be guilty of a Robinson-Patman Act violation when he receives a lower price than paid by one or more of his competitors? The U. S. Supreme Court has interpreted this portion of the Act (Section 2f) to mean that it should apply only to a buyer who, knowing full well that there was little likelihood of a legal "defense for the seller, nevertheless proceeded to exert pressure for lower prices" than paid by his competitors. In the classic Automatic Canteen Co. of America case, the Court suggested that the Commission, to establish a prima-facie case, must show that a buyer who received the benefit of a lower price knew that "the methods by which he was served and quantities in which he purchased were the same as in the case of his competitor." If the methods or quantities differ, the Commission would have to "show that such differences could not give rise to sufficient savings in the cost of manufacture, sale or delivery to justify the price differential, and that the buyer, knowing these were the only differences, should have known that they could not give rise to sufficient cost savings."[14] According to this ruling, the freedom of buyers to negotiate for advantageous prices does not seem to be significantly imperiled by the Robinson-Patman Act.

Discrimination in Brokerage Payments. The law prohibits the payment or receipt of brokerage fees except for services rendered. The purpose of this provision is to correct a practice of granting brokerage fees to large-scale

[11] *Minneapolis-Honeywell Regulator Co. v. Federal Trade Commission,* 191 F.2d, 786–90 (CA-7, 1951); certiorari dismissed (U.S. Supreme Court, 1952), 73 S. Ct. 245.

[12] *Ibid.*

[13] Cf. *Report of the Attorney General's Committee to Study the Antitrust Laws,* (Washington, D.C.: Government Printing Office, 1955), pp. 162–63.

[14] *Automatic Canteen Co. of America v. Federal Trade Commission* (U.S. Sup. Ct., 1953), 346 U.S. 61.

buyers who purchase directly from producers or through a "dummy" brokerage office operated by the regular employees of such buyers. It also prohibits the payment or receipt of brokerage fees that are passed on wholly or in part to the buyers, since the fee must be for services rendered to the seller who pays it. Such a practice results in discrimination against competitors of the favored buyers who failed to receive a similar rebate or price concession.

Prior to the passage of this Act, a certain national food chain received brokerage fees from suppliers through its practice of requiring field buyers to obtain such fees and in turn remit them to headquarters. When such practice was outlawed, the company is alleged to have instructed its buyers to require sellers to deduct amounts equal to the brokerage fees previously granted from the invoices that are submitted for payment. Such deductions were nothing but rebates inasmuch as the buyers of the chain rendered no brokerage service to the suppliers, nor could it be established that the deductions were equivalent to quantity discounts that might be justified by savings effected.[15] In another case the Commission forbade payment of brokerage fees to a "dummy" subsidiary of the sponsor of a nation-wide voluntary chain in the food field.[16]

Another significant case involved an organization which operated partly as a brokerage company and partly as a merchant wholesaler. On merchandise purchased for its own account, the company often received and accepted brokerage fees, in amounts and at rates similar to those received by it when operating as a bona fide broker negotiating sales to other merchant wholesalers. The court ruled that any services rendered by the company on purchases for its own account were services "to itself, as a purchaser, owner, and subsequent seller of the goods purchased, and not to those from whom it has purchased them." Other cases brought under this section of the Robinson-Patman Act involved situations where "agents of buyers were collecting from sellers brokerage which they were passing on to the buyers whom they represented; but if the statute forbids the payment of brokerage to such agents because they represent buyers, *a fortiori* it forbids the payment to buyers themselves."[17]

Discrimination in Specified Allowances. The third major provision of the Robinson-Patman Act is that which *prohibits any payment to a customer, in consideration for any services, unless such payment is made available on proportionally equal terms to all other customers competing in the distribution of such products.* Among the payments here contemplated are those

[15] *The Great Atlantic & Pacific Tea Company v. Federal Trade Commission,* 106 F.2d 667, 3 S. and D. 146.

[16] F.T.C. Docket No. 3783, 1943, affirmed CCA-7, June 13, 1945.

[17] *Southgate Brokerage Co., Inc., v. F.T.C.,* 150 F.2d 607 (CCA-4, 1945); certiorari denied (U.S. Supreme Court, 1945), 326 U.S. 774.

made as advertising allowances, for window displays, or for word-of-mouth promotion by retail salespeople. Illustrative is the case of a wholesale baker who paid $250 per month to a chain organization for advertising the brand of bread made by the vendor. While other customers were willing and able to perform a similar service, they could not secure similar allowances.

Providing compensation to the regular employees of a customer's business has been involved in a number of cases. In one situation a manufacturer of costume jewelry agreed to pay a chain store organization a special commission of 2.5 per cent of the retail sales price of the jewelry sold by it. This was to be used as a portion of the commissions paid by the retail organization to its employees, as an incentive to promote the sale of the particular line of jewelry. This was deemed in violation of the act, since the same arrangement was not made available to other customers who were competing with the chain in the sale of this line of jewelry.[18]

Provision of salespeople known as "hidden demonstrators" by a manufacturer is forbidden unless the same type of sales service is made available on a proportional basis to all retailers served by the manufacturer in question. In a governing case the Commission established the fact that one manufacturer of cosmetics had at the time of the action 125 demonstrators in a selected few of the more than 3,000 retail outlets through which its products were being distributed. In several instances as many as three such demonstrators or sales persons served in a single store. In fact, one store on Fifth Avenue, New York, had in its cosmetics department no less than 40 such employees who were compensated by the respective manufacturers whose products were handled in that store. Not only was the manufacturer against whom action was taken discriminating by giving free sales service to some of his customers and none to others, but he rejected many applications for similar assistance without stating any reason for the action taken.[19]

Effects of the Robinson-Patman Act. There seems to be little doubt but that the Act has had the effect of making competition between the larger distributors, particularly in retailing, and the smaller merchants more equitable. Mass buyers had often enjoyed what may be termed uneconomic advantages, merely because of their importance to the vendors. Many sellers at once revamped their price structures and policies, discontinued certain discounts and allowances, and adjusted quantity discounts in line with the savings effected or economies secured from sales in quantity lots. Other manufacturers seized upon the law as an opportunity for revamping price and discount policies which were undesirable though not necessarily in

[18] *United Cigar-Whelan Stores Corp. v. H. Weinreich Co., Inc.*, 107 F. Supp. 89 (DCNY, 1952).

[19] F.T.C. Docket No. 3133, October, 1944, affirmed CCA-2, June 5, 1946. Cert. denied April 14, 1947.

contravention of the law. On the whole, such modifications in price structures and policies have been to the detriment of mass buyers. Many such buyers have for the first time been deprived of the advertising allowances which for some years have constituted one of their principal sources of income. The same has happened with regard to undeserved brokerage fees and outright price concessions.

To the extent that chains and mail order houses have been somewhat limited by the operation of this law, independent dealers have benefited. The benefit to the latter has come about in two ways. First, large distributors have been deprived of uneconomic, undeserved, and unjustified price discriminations and hence are unable to lower prices to their customers as much as formerly as a means of attracting trade. Second, since manufacturers are forced to charge higher prices when selling to mass distributors, it has been possible for them to reduce prices formerly charged to their other customers, thus tending to equalize somewhat their prices to all customers.

Insofar as independent merchants have benefited under the law, the position of wholesalers who serve them has become correspondingly stronger. As voluntary chains, most of which are wholesaler-sponsored, have thus been deprived of some of their buying advantages, nonaffiliated wholesalers have benefited to some extent. It is difficult to predict with certainty just what the ultimate effect the Robinson-Patman Act will have upon the relative position of each of the various elements of the distributing industry. But it may be said with certainty that thus far the operation of the Act seems to be in the direction of attaining a higher degree of equity in that price schedules seem to be more carefully attuned to differences in costs of distribution than before the enactment of this legislation.

Other Trade Laws. Beginning with the decade of the 1930's, a large number of laws, particularly on a state basis, have been enacted to the end of curbing or regulating certain types of competition. Fair Trade Laws, originating with the states and culminating with the Miller-Tydings Act passed by Congress in 1937, definitely marked a retreat from competition by withdrawing from the jurisdiction of the antitrust laws vertical price-fixing agreements involving competitive trade-marked goods. This type of legislation has been supplemented by many states with so-called Unfair Trade Practices Acts.[20] Chain store tax laws in effect in some states have sought to curb certain types of retailing. In these laws the onslaught on the chains is direct and devoid of the camouflage afforded by such terms as "fair" or "unfair" trade practices. While it is true that one of the motives behind such legislation was to secure additional needed revenue, the main purpose was to curb the growth of chain stores and the multiplication of chain store

[20] For a complete discussion of these two types of legislation, see Chapter 34.

units and to preserve the status quo with respect to independent stores.[21] License and other chain store taxes have also been imposed through city ordinances by a number of municipalities. If they are of the license variety, the taxes are graduated according to the number of stores operating within the city, while the other types of chain store taxes are graduated on the basis of sales or gross receipts, the amount of the tax increasing with the size of the chain. More recently, some municipalities have attempted to place a heavy tax per store on supermarkets.

Many states have enacted antidiscrimination laws, similar in effect to the Robinson-Patman Act. Some of them have gone into the regulation of the marketing of certain commodities. Milk is a case in point. In several states milk-control boards have been set up to maintain retail prices through agreements of distributors to a given price schedule and in other ways to prevent a demoralization of the milk market, and thus assure the farmer of a reasonable price for his product. Much of this program was carried out in conjunction with the attempt of the federal government, through its Federal Milk Administrator, to stabilize the dairy industry.

Municipalities have, in numerous instances, enacted ordinances of the Green River type, prohibiting uninvited house-to-house soliciting in the sale of goods. Many cities, also, have special licensing requirements for various kinds of service businesses, such as television repair or the operation of barber or beauty shops. Some have local laws relating to misleading or deceptive advertising.

Short-Run and Long-Run Relation Between Trade Legislation and Competition. When the whole parade of trade legislation from 1890 down to the present is considered, an inescapable conclusion is that there are many federal and state laws which place some restriction upon business. It is often reasoned, and quite erroneously, that, since such laws restrict business operations and freedom, they also are restrictive of *competitive* activity. Such an argument is somewhat tenable if only short-run effects are considered. Before the Sherman Act was passed, business units felt relatively free (though in contravention of the common law) to engage in combinations and conspiracies; subsequently, such actions were prohibited by federal statute even though they were also unenforceable under the common law. Prior to the enactment of the Clayton Act, the legality of "tying contracts" or exclusive dealing arrangements was largely unquestioned; later, firms found that they did not have perfect freedom to engage in such practices. It was perhaps legal to give large firms substantial advertising allowances and at the same time refuse similar benefits to small dealers before the

[21] For a discussion of chain store taxation, see Chapter 10; also T. N. Beckman and H. C. Nolen, *The Chain Store Problem* (New York: McGraw-Hill Book Co., Inc., 1938), chap. xvi.

Robinson-Patman Act was passed; following this, such discrimination was specifically outlawed.

If by "restrictive of competition" is meant any restraint upon the freedom of a firm to do as it pleases in an unregulated market situation, then clearly all of the laws have had the short-run effect of restricting competitive activity. What is restrictive in the short run may, however, very well be promotive of competition in the long run. By curbing the completely free and unrestrained play of competitive forces, legislation may tend to preserve some reasonable bounds within which rivals may vie with one another for patronage but not in a manner that is contrary to public interest nor unfair to their competitors and thus insure the survival of competition in the long run. Such was clearly the intent of the Congress in passing the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. Even much of our more recent legislation has been of this character. When the collective effects of the Wheeler-Lea Act and the Robinson-Patman Act are considered, substantial rivalry in marketing is not impeded. Prohibitions are directed at circumstances where the result has been a lessening of competition or, according to certain court rulings, where the effect is *potentially* a reduction of competition or where injury to the public is involved.

On the other hand, certain of our legislative enactments must be considered as being definitely restrictive of competition, whether viewed from the short run or long run. In this category fall the laws that encourage agreements or combinations or which force some degree of price standardization upon rival dealers in like commodities. Illustrative are the Fair Trade Laws, to the extent that dealers may be bound even in the absence of contracts when only intrastate commerce is involved. Additional examples are to be found in the provision for marketing orders in the Agricultural Marketing Agreement Act, Chain Store Tax Laws, and Green River Ordinances. Also in this category are the various laws which have exempted special interest groups from the provisions of antitrust legislation, the long-run purpose of which is to foster and preserve competitive activity. Among these are the Webb-Pomerene Act and the Capper-Volstead Act. Finally, as indicated earlier in this chapter, certain of our trade legislation is without the intent or effect of fostering or hindering competition. Some enactments have had as their purpose merely the protection of public interests from unfair or immoral actions of producers and marketing agencies. By enforcing some degree of standardization in what are considered desirable trade practices, they leave the competitive situation of rivals, at least over extended time periods, essentially untouched. Illustrative are the Food, Drug, and Cosmetic Act, the Wool Products Labeling Act, and the Fur Products Labeling Act.

Summary. It has been shown in this chapter that for generations we have struggled to maintain freedom of competition. In the belief that free and

untrammeled competition can be best maintained when business units are small and numerous, all sorts of attempts have been made to prevent bigness. But despite the common law prohibitions, the antitrust laws, the trust-busting efforts of Theodore Roosevelt, and the attack of Woodrow Wilson against the "interests," business giants are a common factor in our contemporary society, and they seem to be operating within the law of the land. Furthermore, we have come to realize that the net effects of big business may be good for society, and that certainly not all of the effects of bigness are bad. On the other hand, a strong undercurrent of thought has developed that competition per se may not be the ultimate in virtue, and that some competitive practices, while not necessarily against good morals, may still be detrimental to business and the public.

All these things have led to a modification in our philosophy toward competition. While we still pay lip service to laissez faire and rugged individualism, while we still cling to the competitive ideal as the dominant force in our economic society, we are much more realistic in day-to-day practice. Consequently, the general feeling now is that competition must be regulated or restrained, just as monopolies must be either regulated or publicly owned and operated. That change in attitude accounts for the greater emphasis upon legislation of a restrictive nature that has prevailed since 1929.

Moreover, federal legislation of the restrictive type tends to foster similar activity by states and municipalities. Sometimes it works in the opposite direction, from state legislation to federal. One thing is certain, however, and that is that legislation breeds legislation and that one law inevitably leads to another. To this there is but one important exception, having to do with laws enacted during a war emergency purely as temporary devices, but even these tend to persist or to be re-enacted in modified form in more normal times. It appears, therefore, that in the future more, rather than less, governmental peacetime interference with, or regulation and control of, marketing activity may be confidently expected.

In some cases the states have gone farther in restrictive legislation than has the federal government. This is well illustrated in the marketing of alcoholic beverages, where the restrictions run the entire gamut from licensing liquor dealers or other retail outlets, otherwise controlling such establishments or their advertising activities, to the sale of such products by the state itself in its own stores operated as a state monopoly.

Since federal and state laws affecting marketing are becoming of increasing importance, it behooves the student of marketing to become familiar with them, their purposes, and actual operation. He must view them especially from the standpoint of their effects on prices, channels of distribution, the various types of marketing institutions, current marketing practices and policies, and above all, their impingement upon producer, middleman, and

the consuming public. Furthermore, it behooves students of marketing constantly to emphasize the need for thoroughgoing scientific research of our marketing system and the full impact of proposed legislation on such a system before the legislation is enacted. Finally, one must bear in mind that the marketing process is extremely dynamic, as are the institutions that perform it, although not necessarily in fundamentals that have emerged from the crucible of experience extending over decades or generations. The need for an open mind in the study of marketing is thus fully evident, just as is the need for ability to approach the manifold problems which are constantly before us in the marketing system in a detached and scientific manner. This is one of the surest ways of promoting genuine progress in the field of marketing in the years ahead.

Questions and Problems

1. List all of the major federal laws bearing principally upon marketing. State in each case whether the law has a long-run effect upon competitive rivalry in the sale of goods and, if so, whether such effect promotes or restricts competition. Briefly explain the basis for your reasoning in each case.
2. What is meant by *laissez faire?* Is it a myth or a reality?
3. In view of the many laws restricting competition, are we justified in assuming that national policy is opposed to competition? If not, what is the explanation for the restrictive legislation?
4. Inasmuch as the Clayton Act is essentialy a duplication of the Sherman Act, how can one explain its enactment?
5. Can a violator be prosecuted under both the Sherman Act and the Clayton Act for the same offense? Why or why not? If action is brought under the Sherman Act, what agency handles it? Does the same agency enforce the Clayton Act? Why is one offender prosecuted under the Sherman Act and another offender for the same general type of violation under the Clayton Act?
6. What are the major fields of activity of the Federal Trade Commission?
7. In determining what is unfair competition, is the Federal Trade Commission governed by any well-established principles? If so, what are they? Would it not be better if the Commission took a more positive viewpoint and determined what is *fair* competition instead of what is *unfair?*
8. As a consumer without any financial interest in any marketing institution, should you favor or oppose:
   a) The Robinson-Patman Act?
   b) A Fair Trade Law?
   c) An Unfair Trade Practices Act?
   d) A chain store tax law?

9. Why was it necessary to pass the Robinson-Patman Act when we already had the Clayton Act and the Federal Trade Commission Act which prohibited certain price discriminations and similar practices?
10. Mass distributors, especially chain stores, have been complaining that the Robinson-Patman Act is punitive and discriminatory and deprives them of many substantial advantages they previously enjoyed, to the detriment of consumers whom they serve. Is this complaint justified? Explain.
11. Among all the various types of marketing institutions, wholesale and retail, which stand to lose and which stand to benefit from the Robinson-Patman Act and in what special ways?
12. Describe the procedure for establishing Trade Practice Rules. If the so-called Group I rules pertain to actions which are otherwise illegal, what is the point of promulgating them as industry rules?
13. It is often asserted that enforcement of many Trade Practice Rules is very lax. Does this mean that no useful purpose is served by promulgating them? Explain.
14. Under the Robinson-Patman Act, how is the phrase, "may be substantially to lessen competition," to be interpreted in a price discrimination action? Explain.
15. According to judicial authority, what conditions would have to prevail for a buyer to "knowingly receive the benefit" of an illegal price discrimination? Explain.
16. In the future, may one expect more or less legislation with regard to marketing? Which trend would be the more desirable? Does the student of marketing have responsibilities in this respect? Explain and justify your answers.

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SUBJECT INDEX*

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